Financial Conduct Authority

Discussion Paper DP16/2

CASS 7A & the Special Administration Regime Review

March 2016

We are asking for comments on this Discussion Paper by 9 May 2016.

You can send them to us using the form on our website at:
www.the-fca.org.uk/dp16-2-response-form.

Or in writing to:

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Contents

Abbreviations used in this paper

Bloxham Final Report	'Final Review of the Investment Bank Special Administration Regulations 2011' by Peter Bloxham, January 2014
Bloxham Interim Report	'Review of the Investment Bank Special Administration Regulations 2011' by Peter Bloxham, April 2013
BRRD	Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, commonly referred to as the 'Bank Recovery and Resolution Directive'
CASS	Client Assets sourcebook
CASS 7A	Client money distribution rules
CASS RP	CASS resolution pack
CCP	Central counterparty
CF10a	CASS operational oversight function
Client assets	Client money and custody assets
CMAR	Client money and assets return
CME	Client money entitlement
CMP	Client money pool
COBS	Conduct of Business sourcebook
CP	Consultation paper
CP13/5	FCA's 'Review of the client assets regime for investment business' (CP13/5) July 2013
DP	Discussion paper
DvP	Delivery versus payment
EMIR	Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories, commonly referred to as the 'European Markets Infrastructure Regulation'
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
FSA	Financial Services Authority

FSCS	Financial Services Compensation Scheme
FSMA	The Financial Services and Markets Act 2000
HMRC	HM Revenue & Customs
IP	Insolvency practitioner
LBIE	Lehman Brothers International (Europe)
MF Global	MF Global UK Limited
MiFID	Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments, commonly referred to as the 'Markets in Financial Instruments Directive'
MiFID II	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, commonly referred to as the 'Markets in Financial Instruments Directive II'
MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments, commonly referred to as the 'Markets in Financial Instruments Regulation'
OTC	Over-the-counter
PLS	Point of last segregation
PPE	Primary pooling event
PRA	Prudential Regulation Authority
PS14/9	FCA's 'Review of the client assets regime for investment business: Feedback to CP13/5 and final rules' (PS14/9), June 2014
SAR	The Investment Bank Special Administration Regulations 2011 and The Investment Bank Special Administration (England and Wales) Rules 2011, commonly referred to as the 'Special Administration Regime'
Treasury	HM Treasury
Treasury paper	The Treasury's response to the Bloxham Final Report, '*Reforms to the Investment Bank Special Administration Regime*'
TTCA	Title transfer collateral arrangements

1. Overview

Introduction

1.1 If an investment firm holding client assets fails, its client estate is generally dealt with by the relevant insolvency practitioner (IP) in accordance with the client money distribution rules (CASS 7A) and the Special Administration Regime (SAR). These two regimes work together to ensure that client assets are returned to their owners as soon as, and as intact as, possible following the failure of an investment firm.

1.2 HM Treasury (Treasury) commissioned Peter Bloxham to undertake an independent review of the SAR.[1] His final report[2] was published in January 2014 (Bloxham Final Report) and contained a number of recommendations relating to the SAR regulations, the CASS rules and the procedures administrators follow in the event of an investment firm failure.

1.3 This discussion paper (DP) sets out our response to the recommendations in the Bloxham Final Report addressed to us and seeks industry views on the discussion points raised. The recommendations aim to improve the speed of return of client assets to an investment firm's clients in the event of its failure and minimise the market impact of its entry into special administration. This DP also contains the FCA's response to the 'speed proposal' on which we consulted in CP13/5, but which was separated from our final proposals in PS14/9, pending the Treasury's response to the Bloxham Final Report.

1.4 Throughout this DP we refer to the Treasury's response to the Bloxham Final Report, *Reforms to the Investment Bank Special Administration Regime* (Treasury paper), which we understand is to be published concurrently with this DP. The two papers should be read together to obtain a clear view of how the CASS and SAR regimes work following an investment firm failure.

1.5 This DP seeks feedback on a number of aspects of the client assets regime, in particular regarding the CASS 7A rules and their interaction with the SAR and general insolvency provisions, and the FCA rules covering client money (CASS 7), custody assets (CASS 6) and the CASS resolution pack (CASS 10).

1 This was required under the Banking Act 2009.

2 Final review of the Investment Bank Special Administration Regulations 2011 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/271040/PU1560_SAR.pdf

Who does this discussion paper affect?

1.6 This DP is relevant to all regulated firms that hold custody assets and/or client money in relation to investment business and in particular:

- their clients
- their banks and custodians, and
- administrators and their advisers

Is this of interest to consumers?

1.7 The topics discussed in this DP will affect investment firms and their clients in the event of an investment firm failure.

1.8 We welcome feedback from consumers and consumer groups on the discussion points contained in this DP.

Context

1.9 Following the failure of Lehman Brothers International (Europe) (LBIE) in 2008, the Treasury created an insolvency regime for investment firms, the SAR. This works with the CASS rules to create the mechanism under which client assets are dealt with in a failed investment firm. The SAR sets out three special objectives for administrators[3]:

- to return client assets to customers as soon as reasonably practicable,
- to ensure timely engagement with market infrastructure bodies and authorities (e.g. clearing houses and exchanges), and
- to rescue the firm as a going concern or wind it up in the best interests of its creditors

1.10 The three objectives have equal importance and are not in any order of priority. The FCA, after consulting with the Treasury and the Bank, may direct an administrator to prioritise an objective if certain conditions[4] are met.

1.11 The SAR is relevant to firms which are 'investment banks', meaning a firm that[5]:

- has permission under Part 4 of FSMA to carry on the regulated activity of safeguarding and administering, dealing in investments as principal or dealing in investments as agent,
- holds client money or custody assets, and
- is established within the UK

3 Regulation 10(1) of the SAR.
4 Regulation 16 of the SAR.
5 Section 232 of the Banking Act 2009.

1.12 As stated above, the Treasury commissioned an independent review of the SAR which resulted in the publication of the Bloxham Final Report. This contained 72 recommendations aimed at speeding up the return of client assets by making CASS and the SAR work better together, reducing legal uncertainty and improving consumer and market outcomes in the event of an investment firm SAR administration.

1.13 We have worked closely with the Treasury and other relevant authorities in responding to the recommendations, including coordinating the publication of this DP with the Treasury's response to the Bloxham Final Report. This approach helps readers to consider each policy individually, but also, when read together, shows how CASS and the SAR can work better together.

What does this paper cover?

1.14 This DP is intended to generate discussion and industry feedback on our proposals. We plan to consider the legislative changes to be made to the SAR (once finalised by the Treasury) together with all feedback received to these proposals, before consulting on detailed changes to the CASS 7A rules. This DP contains:

- **A summary of the 'speed proposal' we consulted on in CP13/5** and explanation of why this is not being implemented
- **A discussion paper (DP)** – our response to the Bloxham Final Report recommendations on which we wish to generate debate and seek industry views. Topics include how to value transactions to determine client money entitlement; transfer of the client money pool (CMP); the need for CASS rules to address lessons learnt from case law; the provision of additional information to clients and administrators and recommendations for the treatment of allocated but unclaimed and de minimis[6] client money, and
- **Our response to other Bloxham Final Report recommendations** where specific industry feedback is not being requested, for example where a recommendation has already been implemented.

Equality and diversity considerations

1.15 We have assessed the likely equality and diversity impacts of these proposals and do not think they give rise to any concerns. We would welcome your comments on any issues identified.

Next steps

1.16 We would like to know what you think of the discussion topics and questions we have set out in this paper. Please submit your comments by 9 May 2016.

1.17 To submit a response, please use the online response form on our website or write to us at the address in the contact box.

6 This means small client money balances that are considered to be uneconomic to pay out.

1.18 We will consider all feedback received and expect to publish a consultation paper (CP) in response to the discussion aspects of this DP later this year, when the legislative changes to the SAR have been finalised. Within this further consultation, we propose to include additional CASS 7A changes consulted on in CP13/5 relating to currency conversion, the definitions of a primary pooling event (PPE) and secondary pooling event, the treatment of post PPE receipts and additions to the CASS RP.

2. List of Bloxham Final Report recommendations to which we are responding

2.1 In this DP we are responding to the following Bloxham Final Report recommendations. Some of these recommendations may also be considered by the Treasury in their response to the Bloxham Final Report.

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7 The numbering and title of these recommendations reflects the Bloxham Final Report, see key recommendations summary table.

3.
Speed proposal response

FCA CP13/5 and the speed proposal

3.1 We consulted on a proposal in CP13/5 to enable client money to be distributed quickly following the failure of an investment firm, based solely on the records of the firm. This was the only method we could see of accelerating the distribution of client money without changes being made to the underlying legislation. Given the proposed changes to the SAR in the Treasury paper, and the feedback we received to this in CP13/5, we are not introducing the speed proposal.

3.2 The Bloxham Final Report contained two recommendations around the speed proposal:

> **"Recommendation 50: FCA involves experienced Insolvency Practitioners, in-house Client Asset specialists at investment firms and expert financial services and insolvency lawyers in formulating any rules relating to the FCA's Speed Proposal if introduced."**
>
> **"Recommendation 51: If the FCA implements 'Speed Proposal', consider mechanism for FCA to "bless" Administrator's conclusion that Speed Proposal can be pursued, as it is reasonable to determine client entitlements from firm records."**

3.3 As we are not proposing to proceed with the speed proposal, we are not proceeding with either of the above recommendations.

Summary of feedback from the speed proposal

3.4 The speed proposal was put forward in CP13/5 as a detailed mechanism to enable IPs to rely on the books and records of a failed firm, and distribute client money within two weeks of its failure. A separate client money pool (CMP) was to be established to hold any residual client money, which would be available to clients who did not appear in the books and records of the failed firm, but should have done. If the IP was not confident in the books and records of the firm, he could revert to a more traditional distribution of client money, focussing on accuracy over speed.

3.5 Just over half of respondents rejected the proposal or preferred that the relevant court judgments should be incorporated into the CASS rules. A small proportion of responses were wholly in agreement with the proposal, the remainder agreed providing certain changes were taken into consideration.

3.6 Significant concerns were raised in relation to the accuracy of the firms' books and records, as client money would be rapidly distributed on that basis. Respondents noted that the IP was unable to rely exclusively on the firm's records following both the LBIE and MF Global failures, receiving decisions from the Court through lengthy litigation on various points around entitlement to client money. The general consensus for those disagreeing with the proposal was that speed should not be prioritised at the expense of accuracy.

3.7 Some respondents highlighted that if firms were compliant with the CASS rules, records would be accurate and there would be no requirement for the speed proposal. We agree that records should be accurate, enabling a quicker distribution. We also agree that accuracy should be reinforced through effective CASS rules and appropriate regulatory oversight, and that the thoroughness of the CASS audit and firms' own oversight also have a role to play. We are seeing that changes introduced by PS14/9 are improving the standard of recordkeeping across the industry.

3.8 Respondents also raised significant concerns regarding IP or administrator liability. It was widely noted that the introduction of a system requiring an IP to base distribution on potentially inaccurate records would be impractical without addressing the risk of litigation arising from this. Parallels were drawn with regimes in the US, Canada and Hong Kong, where the IP does not carry the burden of liability. Although this was considered in the Bloxham Final Report, Peter Bloxham was not 'persuaded that delays in return of client assets have been, to any appreciable extent, attributable to the lack of immunity for the administrators'.[8] Administrator liability is considered further in the Treasury's response to the Bloxham Final Report's recommendation on this issue.[9]

3.9 Respondents also highlighted the principle of fairness and human rights, and the risk of depriving people of their property. It was noted that clients who did not receive a distribution from the initial pool may have to claim from the residual pool, without certainty that there will be sufficient, if any, funds remaining. Leaving the IP with the discretion to determine which clients could claim from which pool, leaves the IP open to litigation. To avoid unfairness, some suggested a percentage distribution of the initial pool (varying between 60% and 75%), leaving more for clients who could not claim from the initial pool. When considering different methods of implementing the speed proposal, we were unable to come to a solution which was fair for clients and compatible with our statutory objective of protecting consumers.

3.10 Some of the larger firms and trade associations noted that client money is often held as collateral for a client's obligations to a firm. This can delay distribution as an IP must determine a client's entitlement, relative to the obligations to a firm. More complex transactions in which client money can be held as security interest with a firm's affiliates can further complicate matters, so only two weeks to determine the accuracy of a firm's books and records may not be practical in the event of a large-scale default. This can be made worse by the release of collateral by a central counterparty (CCP) that has failed to port[10] any transactions.

3.11 In CP13/5, we noted that there were limits to the FCA's ability to improve distribution of client assets, due to the constraints of the wider legal framework within which the CASS rules operate. The speed proposal encapsulated these limitations, going as far as was possible without wider changes impacting on general insolvency law, the SAR and/or EMIR, MiFID and

8 Paragraph 5.7, page 21 of Bloxham Final Report.

9 Recommendation 28: Speedy Returns – Administrators should be protected from any liability if they agree 'speedy' returns to individual clients in straightforward, hardship or small value cases. Clients would surrender the right to complete accuracy, but retain any liabilities to the failed firm.

10 Porting is a term used in derivatives markets referring to the transfer of a client's open positions and collateral to a third party in the event of a firm's failure.

other EU legislation. This was highlighted in the Bloxham Final Report and was interpreted as a need to provide the FCA with more statutory powers to make binding (legal) decisions. We are not looking for statutory powers to oversee administrators' actions and understand that the Treasury has no plans to take this recommendation forward. We were, however, pointing out the inability of the CASS rules to materially enhance the speed of distribution without taking this wider legislation into consideration.

3.12 Several respondents who disagreed with the speed proposal identified the need for wider reform of insolvency law. A number of respondents highlighted making clients a priority over other creditors in the distribution and others noted that costs for the distribution of client assets should be taken from the general estate. The FCA continues to support the amendment of insolvency law in particular allowing a top up of any shortfall in the client estate and paying for administration and distribution costs from the general estate.

4. Discussion paper

4.1 In this chapter we discuss a number of specific Bloxham Final Report recommendations aimed at improving the speed of return of client assets and client outcomes in SAR administrations. We seek to generate industry discussion and receive feedback on these issues, to help inform our drafting of detailed rules. We intend to publish a CP setting out our proposed policy and draft rules once the proposed legislative changes to the SAR have been confirmed.

Transfer mechanism

"Recommendation 1: Introduce a SAR mechanism to facilitate rapid transfer of customer relationships and positions, where feasible. (SAR Objective 1)"

4.2 The FCA supports the ability to transfer client assets after the failure of a firm, as in many cases this would provide a better consumer outcome. Clients can then continue to receive services uninterrupted and avoid loss of value arising from premature closure of positions or loss of tax wrappers. Their client assets would be available so that they would not miss new opportunities to invest and avoid the situation that they may not receive their assets back for a long period of time. A transfer of client assets may also reduce administration costs.

4.3 Any decision to transfer client assets remains with the relevant administrator, and would generally be negotiated as a commercial agreement, alongside the sale or transfer of part or all of the firm's business. The Treasury is consulting on some of the legislative measures proposed in the Bloxham Final Report to facilitate transfers, including the ability to novate client contracts to a transferee firm and the ability to override the requirement for individual client consent to the transfer.

Transfer of client money pool

4.4 The CASS 7A rules currently prevent the CMP from being transferred as a whole to another firm post-PPE, as the rules require the CMP to be distributed directly to the clients in accordance with their entitlements.[11] To facilitate post-PPE transfers within CASS, we propose to amend CASS 7A.2.4R to allow the transfer of the general pool and/or any sub-pool, if certain conditions are met. These conditions include:

- the relevant CMP must be transferred whole (no part transfers may be made),
- the transferee firm must make a number of notifications to clients post transfer regarding how to access their assets, and
- the clients must be entitled to the return of their client money from the transferee within a specified period without exit fee or charges.

11 Sub-pools can be transferred in accordance with Article 48 of EMIR.

The transferee firm must hold the client money as set out in CASS or an equivalent regime protecting money for the clients who are entitled to it. Where the conditions are met, the client money transferred will cease to be client money of the failed firm. If there is a shortfall in the CMP, we would expect this to be allocated to each of the clients who were transferred to the transferee firm and not affect any other clients of that firm. It may be that the shortfall would attract FSCS compensation for eligible claimants, payment either directly to the clients or to the transferee firm for the clients concerned. The client money entitlement (CME) in respect of the transferred business would be the client's entitlement actually transferred, unless otherwise agreed.

4.5 While a part transfer of a business line or client book may often be more attractive to transferee firms and a benefit to transferring clients, it risks detriment to those remaining in the CMP, particularly where a shortfall in client money arises. Only transfers of a whole CMP or sub-pool are therefore proposed, however we also welcome feedback on how a partial transfer might be structured to successfully deal with these issues.

Q1: Do you agree with our proposed mechanism for the transfer of the CMP? If not, please provide reasons and suggestions as to how we could approach this differently.

Q2: Do you consider a partial transfer of the CMP a desirable outcome even though it may mean that some clients suffer a greater share of any shortfall? If yes, please outline how this could operate in practice, and any safeguards we could consider.

Transfer of custody assets

4.6 Currently administrators may negotiate the transfer of custody assets as part of the sale of a firm's business. Alongside the Treasury's proposals to allow a statutory novation of contracts and transfers without individual client consent, we propose a new chapter following CASS 6, setting out the communication requirements when firms conduct such a transfer. This would cover, for example, notifications required and the ability for clients to request the return of their assets from the transferee (see 'Custody distribution rules' in paragraph 4.80 for further information). We would also expect the assets to continue to be held in a CASS, or equivalent, environment, and a transferee firm would need to ensure that it complies with any relevant requirements under the COBS rules.

4.7 We propose that the transfer mechanism for custody assets could be used for a partial or whole transfer of those custody assets held by a failed firm. Although we do not propose partial transfers for client money, we propose partial transfers for custody assets because it is generally easier to identify assets held for clients than money, which is fungible and therefore forms a pool and is not allocated to individual clients. We anticipate that any shortfalls would be considered in the commercial negotiations or dealt with in accordance with the SAR.

Q3: Do you agree with our proposal to codify the transfer of custody assets including partial transfers? If not, please provide reasons why, and suggestions as to how we could approach this differently.

Extend bar date to client monies

"Recommendation 4: Bar date mechanism should be extended to include Client Monies."

4.8 The bar date mechanism in the SAR sets out a process which enables an administrator to distribute custody assets on the basis of claims received before the bar date. Any valid claims received after the bar date would be eligible for any future distribution but cannot disturb previous distributions (a 'soft' bar date). We understand that administrators need a final mechanism (a 'hard' bar date) after which any further client claims can be disregarded in their entirety, so that the client estates (both client money and custody assets) can be closed. The Treasury are consulting on extending the bar date provisions to client money, as well as providing a mechanism for a hard bar date to be established under the SAR.

4.9 We support the Treasury's extension of the bar date to client money and intend to introduce a process in the CASS 7A rules to be followed by firms wishing to set a hard bar date for client money claims. The CASS bar date process would provide safeguards which are necessary as, once a hard bar date has passed, a client will lose their proprietary right to claim against the CMP.

4.10 A client money bar date will only be available to firms that are subject to the SAR, as the legislative framework required to set a bar date and affect property rights will be in the SAR.

4.11 We propose a process to demonstrate that a firm has taken reasonable steps to contact and, if necessary, trace the clients concerned. We consider that this should include, for example:

a. determining, as far as reasonably possible, the correct contact details for the relevant client

b. writing to the client at the last known address either by post or by electronic mail to inform them of their CME, the proposed bar date and the repercussions of not submitting a claim in time, if the firm does not receive a claim from the client within 28 days

c. where the client has not responded after the 28 days referred to in (b), attempting to communicate with the client on at least one further occasion by any means other than that already used, including by post, electronic mail, telephone or media advertisement

d. where the client has not responded within 28 days following the most recent communication, writing again to the client at the last known address either by post or by electronic mail, to inform them that a bar date will be set after a further 28 days, following which the client will lose their CME and may only submit a claim as an unsecured creditor of the firm

e. if the firm has carried out the steps in (b) or (c) and in response has received positive confirmation in writing that the client is no longer at a particular address, the firm should not use that address for the purposes of (d), and

f. making and retaining a record of the client's CME and the amount that the client would have received from the CMP if it had made a claim, on the assumption that all clients received a sum rateable to their CME

4.12 We propose that the firm should use any available means to determine the correct contact details for the relevant client as appropriate, including telephoning the client, searching internal records, media advertising, searching public records, social media, mortality screening, using credit reference agencies or tracing agents. We also propose that the level of contact should be proportionate to the level of each claimant's CME.

Q4: **Do you agree with a hard bar date for client money claims? If not, please provide reasons why and suggest alternative measures.**

Q5: **Do you agree with the process we have set out above setting minimum contact requirements before a hard bar date becomes effective? If not, please provide reasons why, and any suggestions as to how we could approach this differently.**

Extension of the Hindsight Principle

"Recommendation 14: FCA to consider whether Hindsight Principle could be introduced for CASS Client Money Pool Entitlement purposes."

4.13 In the event that a firm entering administration holds open margined transactions at the time a PPE occurs, the administrator will either port the positions to another firm, or close them. By 'closing' a margined transaction we mean, in most cases, the firm opening an opposite transaction which cancels out the relevant contract.

Calculation of client entitlements to the CMP

4.14 Under the current CASS rules, a client's margined transactions that are open at the time of the PPE are valued using notional closing or settlement values as at the time of the PPE. This is the case even if those margined transactions are later closed after the PPE using a different value.

Returned client money

4.15 Where a firm carries out margined transactions for its clients that are either cleared through a CCP or placed with a third party intermediary, the firm is required to place clients' money in a client transaction account either at the CCP or the third party intermediary. When the margined transactions are closed out, the liquidation value for the transactions is credited to the relevant client transaction account and will form part of the CMP.[12]

4.16 When a firm fails there may be a mismatch between the value attributed to that transaction for the purposes of determining a client's CME to the CMP at the point of PPE and the actual liquidation value of the margined transaction in the CMP. Where such mismatches occur, there is the potential for a shortfall or surplus in the CMP to arise.

Hindsight

4.17 In CP13/5 we proposed amending CASS 7A so that clients' margined transactions that are open at PPE are:

i. cleared through a CCP, or

ii. placed with a third party intermediary

iii. are valued at the amount at which they are liquidated to determine CMEs to the CMP.

That is, hindsight should be applied (the Hindsight Principle). The purpose of this was to ensure that the value given to a client's transaction to determine its entitlement to the CMP is equal to

12 Subject to the arrangements around porting in the context of EMIR.

the value of client money returned from a third party in respect of that transaction, to avoid a shortfall or surplus in the CMP. Our position on this issue has not changed.

Wider application of the Hindsight Principle

4.18 The Bloxham Final Report queries whether the Hindsight Principle could be applied more widely to the valuation of other types of client transactions, for example, both margined and non-margined transactions, to determine a client's entitlement to the CMP, stating that 'consideration should be given to seeking to adopt a system of valuation for CMP entitlement purposes which is more likely to reflect the value of assets in the CMP'.[13]

4.19 We are therefore proposing that, where possible, a client's entitlement to the CMP reflects the amount returned from closure of their margined transactions. Clients will have no control over when their positions are closed in the administration, however we consider that applying the Hindsight Principle results in a fairer outcome for all clients. If a client's position decreases in value they would be entitled to the reduced amount, and if it increases, they would be entitled to the increased value.

4.20 We are considering whether hindsight should be applied if the firm has entered into a bilateral OTC contract with a client, where there is no value to be returned to the CMP from a client transaction account. We do not think that this would be a fair outcome because, in the ordinary course of business, the firm would segregate the close out value of the bilateral OTC contract as part of its internal client money reconciliation. The firm should have set aside the appropriate amount of money to cover the position at the final reconciliation. Once the firm has failed, whether the relevant contract has been cancelled or not, the firm will not have the ability to continue to segregate client money on an ongoing basis. Therefore the best result may be for contracts such as these to be valued for the purposes of client money as they were at PPE, otherwise any increase in value of the contract would be to the detriment of other clients within the CMP. The relevant client would still have a contractual claim against the firm for the full value of the contract.

Other bases on which to value client transactions

4.21 Some feedback we received to CP13/5 suggested that contractual provisions should be applied to the valuation of client transactions in place of either PPE or hindsight valuation in certain circumstances. For example, when closing transactions, in some cases the contract will require a transaction to be closed out in a particular way, or the client may have the ability to close the contract on specified occasions/occurrences which may not match the position itself is closed.

4.22 We propose to set out in the CASS rules that the Hindsight Principle will apply to all open margined transactions subject to clearing, so that the client's entitlement to the CMP in respect of such transactions matches the actual sum received into the CMP. Where an open margined transaction reduces in value following PPE, the CCP is likely to cover this from the collateral held in the omnibus account. If the client concerned does not provide additional margin, this may result in other clients' money being used, creating a shortfall in the CMP. Any amounts recovered by administrators in this way should be used to replenish the CMP.

Q6: Do you agree that the Hindsight Principle should be applied to cleared open margined transactions? What potential issues might arise if this is introduced?

13 Paragraph 4.16, page 19 of Bloxham Final Report.

Q7: **Do you consider that there may be other transactions to which the Hindsight Principle should be applied apart from cleared open margined transactions? If so, please explain why.**

Q8: **In what ways could a mismatch arise between a client's CME and the CMP?**

Q9: **Do you consider that contractual provisions or some alternative valuation method should be used either instead of, or in addition to valuation under the Hindsight Principle, and if so, in what circumstances?**

Costs to be deducted from the client estate

4.23 Currently, costs of reconciling and distributing client money and custody assets are generally deducted from the client money or custody assets concerned. Depending on the state of the firm's records this can be a significant amount. The Bloxham Final Report made various recommendations around costs and we understand the Treasury is consulting on the following:

- the costs of recovering assets to be borne by the general estate
- costs caused by breaches of the CASS rules to be borne by the general estate
- costs of distributing the client assets to be borne by the client estate, and
- flexibility for administrators to take these costs from the client estate where the firm estate is insufficient

4.24 This position is different from the usual procedure under insolvency law where any costs must be paid out of the estate which benefits from the work. However, if the firm complies with the CASS rules as a going concern, there should be minimal costs associated with distinguishing between client assets and firm assets. The proposals above ensure that only the true costs of distributing client assets are deducted from the client estate. These costs would involve, for example, the costs of any claims process where the assets are determined to be client assets, the costs of the IP's time sending out client money, and time costs associated with the transfer of assets to either the client or another firm on behalf of the client. We do not believe that there would be significant costs of distributing client assets on the transfer of the client estate to another firm.

4.25 We are not proposing to reflect these changes in CASS, as they will be fully set out in the SAR. However, we are considering whether there is a need to add guidance on this in our rules on the statutory trust (CASS 7.17).

Q10: **Do you consider that we need to make changes to the statutory trust in CASS 7 (client money rules) to reflect the Treasury proposals set out above? If so, what should such guidance cover?**

FSCS recommendations – Firm records

"Recommendation 16: Firms in going-concern mode should do more to ensure their records would assist Administrators and FSCS to understand the status of their clients for FSCS purposes and how their products are structured and consequently whether the FSCS may be able to provide compensation."

4.26 In order to qualify for FSCS compensation, a number of conditions must be met, including:

a. the claim must be against a 'relevant person', broadly meaning an FCA or PRA authorised firm

b. the relevant person must be 'in default', broadly meaning that the person is unable or likely to be unable to meet claims

c. the claim must be of a type that the FSCS can protect. In the context of investment claims, this broadly means that the claim must be in connection with 'designated investment business'[14]

d. the claimant must be an eligible claimant. Individuals will generally be eligible as will some businesses and other organisations, and

e. the 'relevant person' must owe the claimant a civil liability – for example, if a firm has been negligent and this has caused the loss that the claimant has suffered, or the firm is unable to repay client money or custody assets when it had contracted to hold them for the clients

4.27 The Bloxham Final Report suggested that firms put a flag or provide more information in their records on how products are structured, to assist in deciding whether FSCS compensation may be payable. The aim of these flags would be to assist administrators and the FSCS to make the link between a firm's product and whether that firm is carrying on 'designated investment business' in relation to that product, to assess whether condition (c) above is met. We agree that such information may be helpful in the event of insolvency, and therefore should be held in a firm's records to assist an administrator and the FSCS in understanding whether a firm is carrying on designated investment business in relation to a product.

4.28 We therefore wish to generate industry debate on the benefits of:

- requiring firms to show in their records whether providing each of their products constitutes 'designated investment business', and
- requiring this information to be saved as part of the firm's CASS RP

4.29 This recommendation also refers to ensuring that a firm's records assist administrators and the FSCS 'understand the status of their clients for FSCS purposes'. The Bloxham Final Report suggests that a firm's records should flag clients' eligibility to claim compensation, to help assess whether condition (d) above is met. We consider that this will be of limited value, as individuals are generally eligible to claim, and there are too many other variables involved in determining whether, at the time of the firm default, compensation will be payable. Examples of such variables include whether the firm owes the client a civil liability, or the need to distinguish between 'designated investment business' and other business undertaken for the same client, as only 'designated investment business' is generally covered by the FSCS. We therefore do not propose to ask firms to record the eligibility of clients to claim compensation.

14 Glossary definition https://fshandbook.info/FS/glossary-html/handbook/Glossary/D?definition=G283.

Q11: Do you consider that additional information about how a product is structured would assist the administrator and the FSCS in the event of a firm's insolvency? If introduced, what should this include and should any exclusions apply?

Q12: Is there any other information that you think would assist in ensuring FSCS compensation payments are made as quickly as possible?

FSCS recommendations – Statements on entitlements

"Recommendation 17: Firms should consider explaining in customer statements the circumstances in which FSCS might provide compensation if firm failed and elements of a product that would not be covered."

4.30 We agree in principle that clients should be provided with information on when the FSCS might provide compensation if a firm fails and the products or parts of a product that would not be covered. The client statement[15] may be one way of communicating whether or not activities may be covered by FSCS. However, as we say in our response to Recommendation 16, there are a number of conditions that must be met before any FSCS compensation can be paid and any communication to clients would also need to be carefully considered and qualified.

4.31 Due to the complexities of assessing entitlement to FSCS compensation[16], there is a risk that firms may provide inaccurate information. This in turn could generate difficulties and delays to the return of client assets following the failure of a firm. We discuss the possibility of a firm recording in its books and records whether providing a product constitutes designated investment business in our response to Recommendation 16. We think that this information may be outlined in a client statement or by another means of communication with clients. However, any information produced will not confirm client eligibility or whether FSCS compensation may be payable, due to the additional conditions that must be met before the FSCS can determine and pay compensation. It is the FSCS that decides in relation to each claim whether compensation is payable following firm failure.

4.32 In the context of this Bloxham Final Report recommendation, we wish to generate further discussion and industry views on the best way of providing this information to clients. We are also committed to improving the effectiveness of the information consumers receive on financial products and services more generally. We have published a wide ranging discussion paper, exploring how we and the industry can work together to ensure consumers receive smarter and more effective communications.[17] This includes discussion of FSCS-related issues, and we welcome industry feedback on these matters.

Q13: Do you consider that firms should provide more clarity to clients around whether a firm's activities may or may not be covered by the FSCS?

15 By 'client statement', we are referring to the statement that must be provided under the COBS 16.4 rules as well as the information provided to ad hoc client requests under CASS 9.5.4R – CASS 9.5.6R.

16 See response to Recommendation 16, Chapter 4, for further details.

17 See Smarter Consumer Communications http://www.fca.org.uk/static/channel-page/dp-smarter-comms/dp-smarter-comms-index.html

Q14: Is the client statement the best place to provide this and what should this comprise? If not, how else could firms communicate this information to clients and what barriers exist to doing so?

FSCS recommendations – CASS RP

"Recommendation 18: CASS resolution packs to contain sufficient data to enable the Administrator and FSCS to more speedily identify eligible clients and whether FSCS can provide compensation in relation to any parts of the business of the failed firm."

4.33 As noted in our response to Recommendations 16 and 17, we do not believe that it will be possible to provide all the necessary information in the firm's records, and therefore by extension in the CASS RP, to determine a client's eligibility to claim against the FSCS or for the FSCS to determine whether it can provide compensation. We agree, however, that inclusion of additional information in the firm's books and records is likely to be helpful. Therefore details of the structure of products and whether the firm is carrying on 'designated investment business' in relation to a particular product should be included within the CASS RP, to ensure that these are quickly available to an IP on the failure of the firm. We seek industry feedback regarding the benefits of firms including this information in their CASS RPs.

4.34 The proposed designated investment business product flag represents a new record that the firm would be required to implement, and then link to its CASS RP.

Q15: Should firms include details of the structure of products and whether they are carrying on designated investment business in relation to a particular product in the CASS RP?

Other SAR Recommendations – CASS RP

"Recommendation 30: FCA to seek views on proportionate additions to CASS Resolution Packs, to provide maximum assistance to the Administrator and FSCS to achieve speedy return or transfer of Client Assets, and prompt payment of FSCS compensation where available."

4.35 We recognise that any additions to the CASS RP which make payment of FSCS compensation faster would benefit clients of a failed firm. However, as a result of the inherent complexities of assessing FSCS claims, including the need to establish a civil liability, we do not think that entitlement to FSCS compensation can be conclusively captured by firms in a CASS RP.

4.36 We propose to incorporate a number of additional recordkeeping requirements into the CASS RP. The records concerned are already fully in force following the introduction of PS14/9 so we consider that adding these to the CASS RP will assist an administrator in the event of a firm's insolvency.

4.37 The additional documents relate to the following areas:

- title transfer collateral arrangements (TTCA)
- termination of title transfer collateral arrangements
- delivery versus payment exemptions
- client specific safe custody asset records
- treatment of shortfalls
- trustee firm elections
- use of equity and unit trust delivery versus payment exemptions
- prudent segregation records
- alternative approach mandatory prudent segregation records
- clearing arrangement mandatory prudent segregation records
- receipts of client money, and
- client money sub-pools

Q16: Do you agree with these proposed additions? Is there any other information that you think should be added to a CASS RP to assist administrators and the FSCS to achieve speedy return or transfer of client assets, and prompt payment of FSCS compensation where due?

Other SAR Recommendations – reporting formats

"Recommendation 31: Every firm's CASS Resolution Pack should contain a detailed explanation of how client statements are presented. The particular methodology used by a firm should be clearly set out as part of the client statement."

4.38 This recommendation aims to address the lack of standardisation in the presentation of client statements between firms. We agree that mandatory standardisation may not be either practical or desirable. We also agree that the presentation of the information in a firm's client statements should be clear, to enable it to be easily understood by both the administrator and the client. We note that client statements will be accurate when generated but may not reflect the clients' final entitlement, given that the client may have unsettled transactions or may enter into further transactions after the date of the statement.

4.39 We recognise the value of providing this information to an administrator, for example, in helping to establish the basis on which a client is transacting with the firm (e.g. TTCA), and ensuring that clients receive the same explanation in their statements. This should help to minimise any disputes between the administrator and clients due to disparities between the information provided to clients on statements and the information held in the firm's books and records and

which is available to the administrator. We therefore consider a detailed explanation of how client statements are presented to be a proportionate addition to the CASS RP.

4.40 As explained in our response to Recommendations 66 and 68 later in this paper, we have recently carried out extensive work on client statements in PS14/9. We recognise the benefits of clients understanding their statements, and of their receiving the same explanation of the information in those statements as the administrator does. We do not think that this explanation need be in the client statements themselves, firms could provide information about the format and content of statements on their website, for example.

Q17: Do you agree that the detailed explanation of client statements would be a proportionate addition to the CASS RP? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q18: Do you agree that clients and administrators should receive the same explanation of client statements? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q19: Do you agree that a firm could provide this explanation in the client statements themselves and/or on its website? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Administrator power to top up client money shortfalls (final reconciliation)

"Recommendation 46: Where firms use the 'Alternative Approach' to temporarily pay client monies into a general firm account, there should be a mechanism allowing the Administrator to transfer out of credit balances on firm account sums which they consider to reflect the proceeds of payments made by clients, or by third parties for the account of the firm's clients, into a firm account and not transferred into a client account prior to the failure. If this recommendation is adopted, the authorities should consider both whether the Administrator can do this of their own accord, or should require court consent and whether this "top up" principle should have wider application than just where firms adopt the "Alternative Approach".

4.41 The Bloxham Final Report comments on the lack of an effective final reconciliation when a firm fails. This is because firms conduct daily internal reconciliations based on the previous day's close of business. The internal reconciliation works as a check to ensure that the right amount of client money is segregated by the firm, any amount of prudent segregation is properly segregated against recognised risks and properly recorded and that the firm's records accurately reflect the movements in client money concerned. For firms operating the 'normal approach' in which client money is received into, and paid out of a client bank account, this may not result in a significant movement of monies, but remains a very important check. For firms who operate the 'alternative approach' in which client money is received into a firm bank account, this may result in a significant movement of monies.

4.42 When a firm fails, the IP will generally conduct a final reconciliation to calculate each client's CME. However, the IP will generally be prohibited from moving the resulting monies from the firm's account to the client bank account, or vice-versa as it may be seen as a preference for clients under insolvency law. There is an exception for amounts which are clearly identifiable as client money and can be traced into the firm's own accounts. These amounts of client money may be traced and moved into the CMP, although we are not aware of a tracing mechanism having been successfully used.

4.43 This recommendation suggests that the Treasury should consider requiring a final reconciliation, with a resulting movement of money. We understand that the Treasury is adopting this recommendation. This proposes a final reconciliation quickly after the firm failure using the firm's usual method of reconciliation in accordance with the CASS rules, together with any resulting movement of monies to the client bank account, or a movement from the client bank account to the firm's own account as required. The method of reconciliation should be as used by the firm as a going concern. This should be evident from the firm's procedures and, in many cases, the staff that usually perform the reconciliation may still be on site at the firm.

4.44 We support the introduction of this final reconciliation within the SAR regulations, as we consider that this is a considerable improvement on the current position.

Q20: Do you consider that any changes are necessary to either the client money rules or the client money distribution rules to facilitate this proposal?

Codification of case law within CASS

"Recommendation 48: Any codification of CASS Rules should provide an alternative mechanism to the outcomes of Court decisions that are considered unworkable, e.g. by providing a regulatory alternative or substitute to Tracing."

4.45 The Bloxham Final Report recommends that rules should be built into CASS which replaces unworkable general law principles, for example tracing. While our response to Recommendation 49 discusses codification of elements of court judgments relating to CASS more generally, we have focused our response to this recommendation on tracing.

What is meant by tracing?

4.46 Generally speaking, where a trust asset is taken and transferred to a third party in breach of trust, the beneficiary can follow the assets into that third party's hands, and may be able to assert their proprietary rights as owner against that party. Where the asset has been converted into something else, the beneficiary may trace his interest into that other asset. For example, if £10,000 is taken from trust property and used to purchase land, the beneficiary can trace their rights in that trust property to the land in question. In *Foskett v McKeown*[18] the House of Lords made clear that money in a bank account is merely a single debt (a 'chose in action') owed by the bank to the account holder, which is equal to the credit balance of the account holder. In the case of trust money placed in a trustee's bank account, the beneficiary can trace the asset into that chose in action (i.e. the debt claim the trustee has as an account holder against the bank).

18 *Foskett v McKeown* [2000] http://www.bailii.org/uk/cases/UKHL/2000/29.html

4.47 A firm that holds client money for its clients does so under the terms of a statutory trust.[19] Where client money is placed in a trustee firm's own bank account, a client beneficiary can trace the money into that account.

4.48 As discussed in our response to Recommendation 49[20], if a firm fails, the client money pool is made up of client money held in client bank accounts and client transaction accounts, as well as any identifiable client money in firm accounts.[21]

4.49 As discussed in the various LBIE judgments, on a firm's failure, clients may be entitled to trace their interests in the client money into the firm's house accounts where a firm has failed to segregate it. We are not aware, however, of an administrator or client beneficiary undertaking a tracing exercise to date in the context of a SAR (or any other client money case). It is expected that a tracing exercise will be difficult and slow in practice.

4.50 That does not mean, however, that clients should not be entitled to any client money in firm accounts. It would not be the right outcome of this review for clients' rights of action or their abilities to recover amounts held for them by the firm to be limited. In practice, we have seen administrators reach a compromise settlement between the client and the general estate over each of the disputed amounts.

4.51 See our response to Recommendation 46[22] on giving an administrator power to top up client money shortfalls from firm funds. The Bloxham Final Report also recommends consideration of its application to firms more widely[23] which we strongly support. One area where this wider application might be beneficial would be in eliminating the need for lengthy tracing exercises.

Q21: Are there any other court decisions that would benefit from codification in the CASS 7A rules? If yes, please explain which and the reasons why this would be the case.

Codification of the LBIE judgments

"Recommendation 49: Codify the existing CASS regime as now elucidated by LBIE Court judgements."

4.52 The Bloxham Final Report noted that in the event that the speed proposal is not adopted, then the LBIE court judgments should be codified. We agree with the recommendation but think that the CASS rules already adopt this.

4.53 There have been over 30 court judgments from the LBIE administration (including cases unrelated to CASS). One of the most significant decision relating to CASS determined how a statutory trust arises and how to distribute pooled assets. The three key conclusions which arose from the judgment[24] were:

19 CASS 7.17

20 Recommendation 49, paragraphs 4.52 to 4.55.

21 CASS 7A.2.4R(1)(b)

22 Recommendation 46, paragraphs 4.41 to 4.44.

23 Paragraphs 5.18 & 6.22 of Bloxham Final Report.

24 See paragraph 2.9 in CP13/5 "Review of the client assets regime for investment business" http://www.fca.org.uk/static/documents/consultation-papers/cp13-05.pdf

- client money trust arises on receipt and *not* segregation
- the CMP includes monies in the firm accounts as well as in client bank and client transaction accounts, and
- distribution should be on a claims basis, not a contributions basis, i.e. if clients can establish a valid claim then they will be entitled to participate in the CMP[25]

4.54 The CASS rules already contain rules which outline that the firm receives and holds the money as trustee[26], and that the clients' interest in the CMP is based on their claims.[27]

4.55 We have also recently clarified that all client monies, including those in firm accounts should be pooled.[28] The Supreme Court also highlighted the issue of client money movements between the point of last segregation (PLS) and PPE, referring to these as the gap period. Lord Hope and Lord Walker accepted that there was nothing to prevent the final client money reconciliation being conducted as at PPE to take stock of movements during the gap period. See our response to Recommendation 46 on the administrator's power to top up client money shortfalls prior to the firm's failure.

Q22: Do any points in the LBIE judgments require further codification in the CASS 7A rules? If yes, please explain which and the reasons why this would be the case.

Client money buffer

"Recommendation 52: Support use of buffer for insolvency expenses."

4.56 The Bloxham Final Report supports the use of a client money buffer, or a prudent segregation of client money under CASS, to meet insolvency expenses.[29]

4.57 In CP13/5 we proposed that a firm could choose to maintain a prudent segregation of client money in its client bank accounts for costs that may be borne by the CMP following the firm's failure. Having considered the feedback to CP13/5 we did not make this as a rule in PS14/9, however the current CASS rules do not prevent firms from holding such a prudent segregation amount.

4.58 The size of administration costs varies significantly from one firm to another and as a percentage of client money receipts in the CMP.[30] The Bloxham Final Report recognises that, as this is likely to create a shortfall in the CMP, clients may be able to claim as unsecured creditors against the general estate.[31] Costs incurred in an administration may include maintaining firm systems and records, reconstruction of records where firms have failed to comply with CASS recordkeeping requirements, the claims process and potentially significant legal costs of court applications or litigation to resolve any disputes.

25 As opposed to distribution on a contributions basis (or alternative proprietary basis)

26 CASS 7.17.2R as drafted has been in force since 01/07/2014 but the preceding rule underlying that trust arises when a firm receives and holds client money has been in force since 2007.

27 See CASS 7.17.2R (2)(b)

28 CASS 7A.2.4R

29 Paragraph 6.23 of Bloxham Final Report

30 Based on administrators' progress reports to date. These are not final figures, as distribution continues in all the SAR cases.

31 Paragraph 5.22 of Bloxham Final Report

4.59 The Bloxham Final Report recommends that a court should be able to direct the general estate to pay for costs attributable to pre-insolvency firm compliance failures.[32] We agree the general estate should absorb these costs, particularly as clients pay fees to firms as a going concern and these are partly to cover a firm's operational costs, including the cost of CASS compliance. However, we note that distinguishing between the costs of failure to comply with the CASS rules pre-insolvency and the costs properly attributable to the distribution of client money may be difficult and costly for an administrator in practice. This may actually result in disputes and further cost. It will be key to have absolute clarity in the legislation in this area to ensure that the question of attributing costs does not give rise to protracted, costly litigation. The Bloxham Final Report also acknowledges this point.

4.60 We note that the Treasury is proposing changes to the allocation of costs as set out in its paper addressing this point.

Q23: Should firms be encouraged to segregate a prudent margin in respect of administration costs? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Standardisation of data supplied

"Recommendation 67: Consider standardisation of the data supplied or notes provided particularly ongoing transactions."

4.61 The Bloxham Final Report recommends standardisation of data, particularly for on-going transactions. This could cover all forms of data that an administrator may use to determine a client's entitlement. Whilst we understand that a single standard of data across all firms would significantly facilitate the work of an administrator, we do not consider this feasible given that firms use many different systems and platforms.

4.62 There are also existing work streams on data standards and formats for reporting requirements under the FCA, EMIR and MiFID II/MiFIR. The Market Data Reporting Working Group (MDRWG)[33] is responsible for developing an aligned approach by EU national authorities on reporting of transactions, positions, recordkeeping of orders and instrument reference data.[34] This work encompasses data quality, common standards, formats and identifiers and, where possible, reporting requirements.

4.63 The current CASS rules[35] require firms to hold a CASS RP, designed to comprise all the key information and books and records required by an administrator on insolvency, including the firm's most recent internal and external client money reconciliations.[36] We acknowledge that firms may have a variety of report formats, however the underlying data is standardised, and should reflect the CASS requirements.

4.64 We would welcome any further suggestions as to where data supplied to clients or administrators can be standardised to facilitate distribution.

32 Paragraph 5.29 of Bloxham Final Report

33 See http://www.esma.europa.eu/page/Market-Data-Reporting-Working-Group

34 See Article 9 of the EMIR, Article 25 of MiFID /Article 23 of MiFIR, Articles 5, 9, 19, 20 and 60 of MiFID II that outline the various reporting obligations that the MDRWG aims to align

35 CASS 10.2 and CASS 10.3

36 CASS 10.3.1R(7) and CASS 10.3.1R(9)

Q24: What types of data can be standardised to facilitate distribution of the client estate?

Payment of interest

4.65 In CP13/5[37] we proposed that interest earned on the CMP after a PPE should be used to reduce any client money shortfall. The responses received were broadly supportive, with a few requests for clarification. A few respondents noted that the proposal unfairly disadvantaged clients with large cash balances or that it contradicted the post-PPE receipts rule. We do not propose to specify the treatment of interest earned on post-PPE receipts, as these receipts should be distributed to clients with little delay.

4.66 We view interest earned on a general client pool between PPE and final distribution as earned on all client monies pooled together and pro-rating such interest according to cash balances per client would involve more time and costs. However we are considering whether instead, any interest earned on the CMP should be payable to clients on a pari passu basis[38] instead, in recompense for suffering the firm's administration. It would also help level the playing field with the general estate, where interest is payable on claims where there is a surplus in assets. Such interest would be paid into the CMP, but accounted for separately. A de minimis value of £5 could be applied for retail clients and £10 for professional clients, to help offset consequential distribution costs, and only these de minimis balances would be used to offset the likely client money shortfall. Interest earned on designated client bank accounts following a secondary pooling event[39] should be allocated to the relevant clients.

4.67 Paying interest earned to clients on a pari passu basis will align CASS 7A to the interest rules applicable to firms prior to their failure.[40] This proposal could also help address the incentive on clients to arbitrage their claims between the general and client estates. This arises as general estate claims are entitled to receive interest[41] (currently at 8% in the UK except in Scotland where it is 15%), whereas claimants against the CMP are not. Such arbitrage is considered to have contributed to the delays and additional costs suffered by clients following the LBIE administration, and led to the recommendation under the Bloxham Final Report that rights to such income should be reviewed and clarified in the SAR. We welcome comments on the two possible treatments of interest suggested above, and how these would be paid in practice. We seek industry views about whether a payment to clients would be appropriate in all circumstances, such as where claims have been assigned to the FSCS.

Q25: Which of the above proposed options for the treatment of interest would be preferable? And how should these be apportioned and paid out?

Q26: Do you agree with our proposed de minimis values? If not, please provide reasons why and suggest alternative values.

37 Question 6 of CP13/5: Do you agree with the proposals regarding treatment of interest and currency conversion? If not, please provide reasons.

38 This means distributing the interest to clients on an equal basis.

39 An event that occurs in the circumstances described in CASS 7A.3.1R (failure of a bank, intermediate broker, settlement agent or OTC counterparty: secondary pooling events).

40 CASS 7.11.32R

41 Under S. 17 of the Judgments Act 1838 (as amended) interest is payable on claims against the general estate where there is a surplus in assets, and the debt has been proved, from the date of entering administration until the date of the payment of the proved debt(s).

Treatment of allocated but unclaimed client money[42] & de minimis balances following PPE[43]

4.68 There is currently no provision in the CASS 7A rules for the post-PPE treatment of either allocated but unclaimed client monies or de minimis balances. This has resulted in the submission of a formal CASS rule modification request in each SAR administration reaching this stage of distribution. We recognise that an IP cannot retain unclaimed client money indefinitely, but are equally mindful that a client must be given sufficient opportunity to claim their money. In CP13/5 we therefore proposed to allow an IP to use any unclaimed CMEs to make good a shortfall in the CMP, provided certain reasonable steps had been taken to trace the clients concerned. The proposed steps included:

- locating current contact details of the clients
- writing to the client to inform them that the firm no longer intends to treat the entitlement as its client money and that it has 28 days to contact the firm, and
- attempting to communicate with the client at least three times by other means (e.g. phone or advertisement) where the firm cannot get in touch by post or email

4.69 A handful of respondents felt it was unfair to use one client's money for the benefit of another, but the majority strongly supported the proposal to use unclaimed client monies to rectify CMP shortfalls. Comments were also received in relation to ensuring that the reasonable steps required to trace clients do not deplete the CMP or delay the distribution process and querying how such unclaimed monies would be treated in the event of there not being a shortfall.

4.70 Having considered these comments, we propose to re-consult along broadly similar lines, and to apply the steps outlined above. We do not intend to replicate the rules for going concern firms, which require firms to ensure clients have a legally enforceable, unconditional undertaking to make good any valid claim before being permitted to pay away any unclaimed balances.

4.71 Feedback to CP13/5 proposed that an IP should be subject to less onerous reasonable steps than firms in going concern mode. We do not agree that a less onerous standard should apply to an IP, as clients of a failed firm do not retain a future right to claim against the client estate. We do recognise however that a firm may have taken steps to trace a beneficiary of an unclaimed CME prior to its insolvency. Where this can be proved, we agree that those steps can be considered as part compliance with the IP's requirements, although note that all clients must receive relevant notifications that the firm is in insolvency.

4.72 All unclaimed client monies would be used to make good a shortfall in the CMP:

- following reasonable steps taken by the IP to trace the clients
- where the client has been traced but declines to claim their entitlement, or
- the balance is 'historic' and there has been no movement on the account for the previous six years

42 Question 4 of CP13/5: 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.

43 Question 5 of CP13/5: 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.

4.73 In the event of a shortfall having been met, or not arising, we propose that any residual surplus will become due to the firm in line with the statutory trust waterfall provision at CASS 7.17.2(5)R. We note this is counter to the general principles of trust law, which state that a trustee should not benefit financially from his position as trustee, however the client estate will have received a full return of assets.

4.74 We consider that the steps outlined represent the minimum required. We expect that the efforts expended on tracing a client will be proportionate to the value of the CME concerned, with greater efforts made to trace clients with larger CMEs.

4.75 These proposals align the treatment of such balances more closely between the going and gone concern rules, and the new requirements introduced in PS14/9 relating to unclaimed and de minimis balances for going concern firms.[44]

4.76 We note that, should the IP implement a hard bar date for client money then these amounts would be dealt with accordingly and transferred to the general estate. However, a hard bar date may not be appropriate for all firms. Certain firms whose client money would be dealt with in accordance with the CASS 7A rules will not be subject to the SAR (e.g. firms who operate a peer to peer lending platform) and the IP may not choose to impose a bar date under the SAR. We are therefore considering including this mechanism within the CASS 7A rules.

Q27: Do you agree with our proposed treatment of unclaimed client monies? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q28: Do you consider that an equivalent provision for unclaimed assets would be beneficial? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

De minimis amounts of allocated unclaimed client money entitlements

4.77 There is no rule at present setting out the treatment of de minimis unclaimed client money balances post-PPE. CP13/5 proposed that an IP use allocated but unclaimed balances of less than or equal to £10 for any one client to make good a shortfall in the CMP, with fewer reasonable steps than would otherwise be required.

4.78 We received a considerable amount of feedback, with around 60 responses to this question.[45] Almost all feedback was supportive in principle and most respondents recommended a tiered approach and a higher minimum threshold.

4.79 PS14/9 introduced a de minimis threshold of £25 for unclaimed balances in going concern mode for retail clients and £100 for other clients. We propose to adopt the same thresholds for aggregate claims against firms in administration. At least one attempt must be made to contact the client to return the balance, using the most up-to-date contact details held by the firm and

44 Unclaimed custody assets may be paid to charity in specie (i.e. in their existing form) or following their liquidation after a period of 12 years since the firm last received instructions. Our client money rules allow firms to pay away unclaimed client money entitlements to charity after six years of no movement on the account.

45 Question 4 of CP13/5: 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.

the firm must wait at least 28 days after the communication has been made before releasing the balance of unclaimed client money. The firm must also make and retain records of all such balances released from client bank accounts. We welcome feedback on whether this provision should also be extended to balances which have been claimed, but which are uneconomic to pay out, and if implemented, what level this should be.

Q29: Do you agree with the proposed treatment of de minimis client money entitlements? What minimum steps are proportionate and how should these be tiered?

Q30: Should this proposed rule include claimed de minimis balances where these are uneconomic to distribute and if so, what minimum level should this be set at?

Custody distribution rules

4.80 At present, while CASS 7A provides a distribution regime for client money, there is no equivalent process for custody assets.

4.81 The Bloxham Final Report questions whether there is a need for a mechanism to allow clients with very straightforward relationships with a failed firm (e.g. a straight custody holding with no contractual set-offs) to be separated from other clients whose assets are held under more complex contractual arrangements[46], to speed return of the former's assets. Given the proposals currently under discussion in respect of the SAR and CASS 7A, as well as arising from MiFIR and other regulations affecting assets, we welcome industry views on the benefits of including a distribution process for custody assets within CASS.

Q31: Should the FCA consider introducing distribution rules within CASS for custody assets? If so, what provisions should these contain?

Third country UK branch insolvencies

4.82 If clients hold custody assets or client money with firms which are incorporated outside the UK, it may be that those client assets are held subject to the law of the country of incorporation. If such a firm were to fail, the firm may be wound up under the law of the country of incorporation and not English law and the SAR may not be relevant. In these cases, the relevant insolvency regime may lead to a potentially less favourable outcome for UK clients. We therefore remind firms that they need to make an appropriate disclosure of this risk to their clients.

46 See paragraph 8.94 of the Bloxham Final Report.

5.
Response to further recommendations

5.1 This chapter sets out the FCA's response to a number of additional recommendations in the Bloxham Final Report. The full listing of recommendations to which the FCA is responding is on page 9, while chapter 4 'Discussion paper' responds to recommendations where we wish to generate industry discussion and on which we seek feedback. This chapter provides our response on a number of additional recommendations where specific industry response is not being requested, for example where a recommendation has already been implemented.

Facilitating transfers – Use of nominee companies

"Recommendation 3: FCA should consider encouraging firms, in appropriate cases, to use a wholly owned subsidiary as the nominee company to hold legal title to client investments (other than cash)."

5.2 The Bloxham Final Report recommends that the FCA should encourage firms' use of wholly owned nominee companies to register clients' custody holdings, to facilitate their rapid transfer in the event of the firm's failure.

5.3 The CASS rules already allow clients' custody assets to be registered in the name of a wholly owned nominee.[47] However, CASS also permits firms to register custody assets in the name of:

i. the client

ii. a nominee company controlled by an affiliated company or a third party (provided certain requirements are met), and

iii. the firm itself (again provided certain requirements are met)

5.4 We consider that it is better to register legal title to custody assets in the name of the client as, in the event of a firm failure (or a custody asset shortfall arising), the ownership of those particular assets will be clear. Alternatively, registering assets in the name of a nominee company provides the security of assets held in a bankruptcy remote company. However, some jurisdictions do not allow registration of custody assets under a nominee structure, while others require registration in the name of the client or the firm. Current CASS provisions enable firms to meet local registration requirements and restricting this may prevent firms from holding custody assets in certain jurisdictions. An added safeguard has been introduced in PS14/9 since the Bloxham Final Report to restrict a firm from registering its own custody assets in any nominee name intended to register clients' custody assets. This increases the likelihood that the firm or an administrator would be able to transfer client assets promptly before or after the failure of a firm to another entity.

47 CASS 6.2.3R

Relationship between CASS & SAR rights

"Recommendation 10: Ensure relationship between client's rights under CASS in respect of Client Assets and its rights to make claims as a creditor are clearly set out and understood and do not operate unfairly to other creditors."

5.5 We support this recommendation and recognise the benefit of clarity between a client's rights under CASS arising from the holding of client money and assets and their rights to make claims as a creditor. However CASS rules reflect the position of a client money claim under the statutory trust and CMP. We do not have the ability to change other fundamental legal rights, so the CASS rules are not the place for the clarification of legal claims against the general estate.

FSCS recommendations – Shortfalls

"Recommendation 15: FCA should consider extending FSCS compensation for portfolio transfers to cover shortfalls in Custody Assets as well as Client Money shortfalls (provided they fall within the scope of FSCS protection)."

5.6 The Bloxham Final Report[48] recommends that the FSCS should have the ability to pay compensation for a shortfall in client assets to a firm taking over a failed firm's business, rather than paying this directly to the investors who have suffered the loss. In 2012, the FSA recognised the operational benefits to the FSCS as well as to clients of such a change, and introduced this in relation to client money[49], subject to a number of conditions. In particular, the firm must be willing to accept the payment and must credit the accounts of each client with the part of the compensation due to that client.[50]

5.7 In our consultation on changes to the Compensation sourcebook[51], we proposed a similar change for shortfalls in safe custody assets. The consultation period ended on the 29 February 2016 and we are currently considering the responses received.

Other SAR recommendations – Restrictions on status change ('switching')

"Recommendation 32: Clarity regarding status of professional clients who, having contracted out of CASS, seek to switch back from unsecured creditor to client status, to maximise their protection. Switching only to be allowed to take place after the firm's records (and if necessary transfers between firm and client accounts) has been updated to reflect the client's change to protected client status."

5.8 The Bloxham Final Report[52] notes that professional clients that have contracted out of CASS protections may try to 'switch back' into the CASS regime in the run-up to a firm's insolvency. This leads to potential uncertainty if the switch is not effective or is not adequately recorded in the firm's records and as a result, can cause delay in distribution. This was noted as an issue in particular in the MF Global failure.

48 Paragraph 8.31 of Bloxham Final Report.

49 See FSA's Policy Statement PS12/15 – Financial Services Compensation Scheme: changes to the Compensation sourcebook

50 COMP: 11.2.3AR(4)

51 CP15/40: Financial Services Compensation Scheme: changes to the Compensation sourcebook, issued November 2015.

52 Paragraph 8.59 of the Bloxham Final Report.

5.9 As long as certain conditions are met, CASS permits firms to take full ownership of their professional clients'[53] assets to secure or otherwise cover present or future, actual, contingent or prospective obligations. This is commonly referred to as TTCA. Where these arrangements are entered into, the client assets that are the subject of the arrangement cease to be client assets and become the firm's own assets.

5.10 We also agree with the recommendation that TTCAs need to be adequately recorded and that there should be a mechanism to make clear when the switching takes effect. We have already amended our rules accordingly.

5.11 The final rules introduced in PS14/9[54]:

i. require all firms to have a written agreement in place for TTCA, and

ii. stipulate the process firms must follow should a client request protections under CASS for assets and monies otherwise subject to TTCA. This process includes:

- the firm ensuring that both the client's request and the firm's response are documented in writing
- on agreeing to a request for protection, the firm is obliged to notify the client of its agreement and to state when the protection will come into effect, and
- in determining when the protection will come into effect, the firm taking into account any relevant terms in the client agreement, and the period of time it reasonably requires to update its records and to segregate the custody assets or client money

5.12 While CASS currently permits retail clients to enter into TTCA, under MiFID II these arrangements will no longer be available for retail clients.[55]

FCA power to make determinations

"Recommendation 44: As an alternative to Court, an FCA power to make binding rulings on points unclear or not covered by CASS, in individual cases."

5.13 Recommendation 44 seeks to address the need to have an alternative process to the potentially costly and lengthy court process to decide matters not expressly covered by CASS that may arise in the context of a firm in the SAR.

5.14 We support the underlying intention to limit the need for the Court's involvement in the SAR process and see the rationale for giving the FCA power to make binding rulings. However, as outlined below, there are a number of reasons this is likely to have practical difficulties, and we therefore do not propose to implement this recommendation:

- in a number of CASS-related matters that have gone to Court to date, the decision has resulted in some creditors (whether within the client estate or across the client and house

53 It should also be noted that the CASS rules currently permit firms to enter into TTCAs with retail clients as well, but to a more limited extent (such arrangements are not permitted in the context of contracts for difference or rolling spot forex contracts that are futures).

54 See CASS 6.1.6R – 6.1.9G and CASS 7.11.1R – 7.11.13G

55 See MiFID II Article 16 (10): http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0065

estates) gaining and others losing in terms of an increased or reduced pay out. The FCA is unlikely to be seen as sufficiently neutral to determine such cases, and there may also be human rights implications

- it seems likely that all parties would wish to be represented in such matters and this would give rise to a process that mimics the court process, potentially losing its perceived advantages

- one of the benefits of doing business in the UK is recourse to the UK legal system should participants believe they have a valid dispute

FCA powers

"Recommendation 47: FCA and Treasury should identify legislative constraints under which FCA works in this area to consider whether to empower FCA to operate a more effective regime to protect client assets in going concern mode and also on the failure of an investment firm."

5.15 FSMA[56] provides the FCA with the power to create rules. The CASS rules create a statutory trust[57] and a fiduciary relationship between the firm and its client, under which client money is in the legal ownership of the firm but remains in the beneficial ownership of the client. As noted in CP13/5 when advocating the speed proposal, the FCA is limited in what we can do to increase the speed of return of client money under our existing powers.

5.16 This restriction arises because the CASS distribution rules operate in tandem with the SAR regulations and the general framework of insolvency law applicable in the event of a firm's insolvency. Whilst we can make amendments to the CASS rules, it is not in our power to implement measures that extend into the SAR regulations or insolvency law and which we consider would benefit clients in insolvency (for example, remedying client estate shortfalls using the assets of the general estate).

5.17 We support the intention behind the recommendation, but as discussed under Recommendation 44 in relation to the FCA making binding rulings, we consider that providing the FCA with such powers may not have the desired effect.

Segregation/multiple pools

"Recommendation 53: Create regulatory requirement for clear 'virtual' segregation in a firm's records between securities purely held on a custody basis and others, such as those which may be charged back to the firm."

5.18 The Bloxham Final Report recommends separation between securities that are held under custody and those that are subject to more complex activities (e.g. securities lending or re-hypothecation).[58]

56 Section 137B (1)(a)

57 CASS 7.17

58 See paragraph 8.97 at Recommendation 53 of the Bloxham Final Report.

5.19 We understand virtual segregation to mean that securities subject to different activities are held in separate accounts and that they are recorded separately in firms' books and records. We support the principle of the recommendation and believe that market practice and existing CASS rules already ensure that there is sufficient distinction.

5.20 Firms who carry out securities lending and re-hypothecation[59] generally hold these securities in separate designated accounts.

5.21 The CASS rules also have an inherent safeguard to ensure securities that can be re-hypothecated or lent are kept separate from securities held on a pure custody basis. The rules prevent clients' assets being used for the firm's account or the account of another client without prior consent and require the firm to have adequate systems and controls to ensure this.[60] This is especially relevant in the event of failed settlement, where one client's assets within the same omnibus account[61] can be used to settle another client's trade, provided this consent and the necessary systems and controls are in place. To prevent using custody assets for which clients have not provided their consent, firms typically maintain a separate omnibus account structure.

FCA/PRA roles – guidance note

"Recommendation 58: Guidance note on FCA/PRA roles in SAR cases."

5.22 In the event a firm enters administration, the SAR imposes a specific duty on the administrator to liaise with the regulator. Since the SAR was established, the FSA, previously the single regulator for investment firms, was replaced by the FCA and PRA. Both the FCA and PRA have responsibility for failing firms if they are dual-regulated.[62] The Bloxham Final Report recommends that the FCA and PRA publish a guidance note, clarifying their respective roles in SAR administrations. This guidance would ensure that each regulator understands their respective roles and the administrator knows which regulator they need to engage with on a particular issue.

5.23 We have considered the recommendation and do not think it necessary to introduce such a note, given that guidance is provided elsewhere, for example in the Treasury's Code of Practice.[63] This sets out the specific roles of the FCA and PRA in the event of a firm failure and has recently been updated to reflect regulatory developments, such as the implementation of the Bank Recovery and Resolution Directive (BRRD). In addition, the FCA expects a close working dialogue with the IP as well as all other relevant authorities when a firm is subject to the SAR, enabling any queries to be addressed as they arise.

59 The practice by firms of using a client's collateral as their own, for example, in return for lower borrowing costs or a rebate on fees in accordance with a client contract.

60 CASS 6.4.1R

61 A client account containing money or assets for more than one client.

62 These are firms deemed 'significant' to the UK financial system (consisting of circa 1,400 firms that include banks, building societies, insurers and systemically important investment firms.

63 HM Treasury, Banking Act 2009: special resolution regime code of practice (March 2015) – https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/411563/banking_act_2009_code_of_practice_web.pdf

Behavioural recommendations

5.24 In the Bloxham Interim Report, Peter Bloxham notes that his terms of reference specifically instructed him to consider 'practical and non-legislative changes' that could be implemented to improve the delivery of the SAR objectives. We comment on a number of 'behavioural recommendations' below.

Good recordkeeping

"Recommendation 65: Good recordkeeping essential: Some firms need to improve quality of records. Practices of reconciliation of firm and client or counterparty records need to be enhanced."

5.25 We agree that accurate recordkeeping by firms is essential. Both the Bloxham Interim and Final Reports note the complexities facing an administrator in an investment firm failure and the importance of accurate records in preventing delay in the distribution of the client estate. The administrator must work with the records that are available at the time of failure. The need to reconstruct books and records that should have been in place can add significant costs and delay to the return of client assets, adversely impacting client outcomes.

5.26 The CASS rules therefore place great emphasis on recordkeeping, with extensive high level systems and controls and detailed recordkeeping rule requirements. Firms are required to be able to determine at any time and without delay, the client money or assets held for one client from that held for any other or for the firm itself. PS14/9 introduced a significant number of additional requirements, some of which were designed to address lessons learned from the LBIE and subsequent SAR administrations.

5.27 All CASS investment firms are required to obtain external assurance on their CASS compliance, including recordkeeping, on an annual basis.[64] We have focused on improving the client asset report and have been working with auditors and the Financial Reporting Council (FRC) to ensure that these audit reports are of a high standard. We maintain a process of reviewing each 'adverse' or 'except for' CASS audit report as a tool to determine any appropriate supervisory action.

Clients encouraged to review statements

"Recommendation 66: Clients should be encouraged to review statements received from firms."

5.28 While we acknowledge that a more engaged and informed client population could have a positive impact on our regime, it is not possible for us to ensure that clients review and understand their statements. Our rules cannot directly control consumer behaviour, only the conduct of the firms we regulate. We wish to remind firms therefore of their important obligations to clients under PRIN[65], CASS[66] and COBS.[67] We encourage efforts to help clients engage more readily with the communications firms provide so that they are as fully informed

64 See SUP 3.10, Duties of auditors: notification and report on client assets

65 PRIN 2.1, see Principle 7 in particular.

66 CASS 9.4

67 COBS 4.2 and COBS 16.1

as they can be of their own positions when the firm is a going concern and in the event of firm failure. In this context, our response to Recommendation 31[68] explores the explanation of statements and the provision of further information by firms, which are examples of other means of driving this change.

5.29 In June 2015 we published DP15/5, Smarter Consumer Communications[69]. This paper explored how we and the industry can work together to improve the information consumers receive about the financial products and services they are considering buying or already have. We encourage firms to consider the issues raised in that DP when communicating with clients.

Client understanding of statement contents

"Recommendation 68: Firms to make sure clients (especially retail clients) should be able readily to understand contents of client statements, particularly in relation to the status of ongoing trades. Regulators should ensure this."

5.30 As set out in our response to Recommendation 31[70], we agree with the need for clarity in the presentation of client statements, to ensure that these are readily understandable. A detailed explanation may assist clients in this respect, but as long as this information is readily available, we consider that this need not be provided in the client statements themselves.

5.31 PS14/9 updated the CASS rules to remind firms of their obligation to comply with the COBS reporting requirements and CASS now requires firms to provide statements of client assets at a client's request.[71] This provision increases transparency, enhances client awareness and improves client outcomes. If information provided to clients is of a high standard and readily understandable, the distribution of client assets is less likely to be delayed or impacted. In light of these recently introduced changes, we do not propose to make any further amendments to client statements.

Regulators & regulated to understand CASS

"Recommendation 69: Client asset and money rules need to be fully understood by both regulators and the regulated."

5.32 The Bloxham Interim Report noted this recommendation and that implementing the behavioural recommendations would "require a combination of action or encouragement by regulators and other authorities and establishment of best practice standards by individual firms and the market, with prompting from the (professional at least) client community".[72] We agree that the need for this understanding goes beyond the 'regulators and the regulated' and extends to the clients themselves, members of the legal profession, auditors and administrators.

5.33 We consider it helpful to maintain channels of communication between the CASS Department and firms. We have also previously held Q&A sessions as a further opportunity for firms to ask questions on the CASS rules following the introduction of PS14/9.

68 Recommendation 31, paragraphs 4.37 to 4.39.
69 See Smarter Consumer Communications https://www.fca.org.uk/news/dp15-05-smarter-consumer-communications
70 Recommendation 31, paragraphs 4.37 to 4.39.
71 CASS 9.5.4R – CASS 9.5.9R
72 See paragraph 5.37 of the Bloxham Interim Report dated April 2013.

5.34 CASS medium and large firms are required to appoint a CF10a[73], who has responsibility for the operational effectiveness of that firm's CASS systems and controls, CASS governance and oversight and submission of the firm's CMAR.[74] CASS small firms are required to appoint a CASS oversight officer who has responsibility for the firm's operational compliance with CASS and reporting to the firm's governing body.[75] These individuals' responsibilities will include ensuring that relevant staff at the firm have knowledge of CASS and the firm's CASS compliance processes. We intend to continue having regular discussions with CF10as.

5.35 Broadly speaking, all CASS firms are required to obtain an annual CASS audit. This provides an independent assurance of firms' compliance with the CASS rules and how firms implement them.

Firm's intra-group relations to be clear and transparent

"Recommendation 70: Firm's intra-group relations need to be clear and transparent: firms should remove any ambiguities in their intra-group contractual and entitlement arrangements. Regulators should focus on this and consider whether CASS resolution packs for groups should contain copies of the principal long-term intra-group agreements."

5.36 We agree that a firm's intra-group relations need to be clear and transparent. The CASS rules are specific to legal entities[76], however groups may be structured along business and/or product lines and across entity. Our rules require that firms:

> "…make adequate arrangements so as to safeguard clients' ownership rights [of custody assets], especially in the event of the firm's insolvency…"[77] and
>
> "…when holding client money, make adequate arrangements to safeguard the client's rights and prevent the use of client money for its own account…"[78]

5.37 In addition, firms must have adequate organisational arrangements to minimise the risk of the loss or reduction in value of client assets, or of rights in connection with client assets, as a result of misuse, fraud, poor administration, inadequate recordkeeping or negligence.[79] It is clear that any intra-group arrangements that put clients' rights to their client assets at risk would breach these requirements.

5.38 All CASS firms are required to maintain a CASS RP. Each entity must maintain its own separate entity-specific CASS RP. Our rules[80] currently require that each entity within the group includes, within its CASS RP, agreements and letters relating to the holding of client assets and this requirement applies whether or not those arrangements exist between entities in an intra-group structure.

73 CASS 1A.3.1AR. From 7 March 2016, firms are required to appoint the CASS prescribed responsibility to a senior manager under the 'Senior Managers Regime'.

74 The new Senior Management Regime that will be applicable to 'relevant authorised persons' (RAPs) is currently being finalised. RAPs that are also classified as CASS medium or CASS large firms will continue to be required to appoint an individual with the same responsibilities as those set out in CASS 1A.3. However, they will not be referred to as CF10as.

75 CASS 1A.3.1R

76 CASS 1.3.2R

77 Article 13(7) of MiFID and CASS 6.2.1R. This is repeated in the recast MiFID II at Article 16(8).

78 Article 13(8) of MiFID and CASS 7.12.1R. This is repeated in the recast MiFID II at Article 16(9).

79 CASS 6.2.2R and CASS 7.12.2R

80 CASS 10.2.1R(5)

Communication between the FCA, FSCS and HMRC

"Recommendation 71: Improvements to communications should be considered: FCA, FSCS and HMRC should explore whether dialogue and co-operation between them on SAR cases could be improved; making sure the existing gateways for exchange of information are adequate. These authorities should also consider whether there are any lessons from the cases to date. The complexities of the circumstances in which the FSCS may be able to provide compensation would be one example."

5.39 The Bloxham Final Report suggests that improvements to communication, dialogue and co-operation between the FCA, the FSCS and HMRC on SAR cases should be considered and that these authorities ought to reflect upon whether there are any lessons to be learned from SAR cases to date.

5.40 The Bloxham Interim Report stated: "there will be instances, certainly in relation to retail clients, where the return of the client asset or money could be detrimental, and where his interest is to see the asset or money transferred to a solvent investment firm. This applies notably to tax favoured products such as ISAs or SIPP portfolios. For these products, an element of concertation (i.e. dialogue and co-decision) with HMRC may be required as part of an effective and efficient process."[81]

5.41 We recognise the need for appropriate co-ordination and communication, and the agreed frameworks for this are set out in the various memoranda of understanding between these three authorities, as well as with the PRA and the Bank of England. In addition there are existing legislative gateways which enable disclosure of information between these authorities.82 While further improvement is always possible, we consider that the existing framework allows the exchange of information between the relevant authorities on SAR cases, and that these have worked well in the SAR insolvencies to date. A significant number of additional firms have entered special administration since the Bloxham Final Report was published83, providing additional opportunities to learn lessons. These new firm failures have highlighted the value of early engagement and increased awareness of the roles and processes of the respective bodies as well as insolvency practitioners and we consider that the communication channels have worked well to date.

Testing changes to the SAR regime

"Recommendation 72: Changes to the SAR regime should be tested. At a future point, the authorities should consider operating 'test cases' of a hypothetical SAR taking into account improvements made as a result of this review or otherwise, any changes the FSA makes to the CASS rules following its own review of those and, importantly, taking account of EMIR."

5.42 The number of firms entering a SAR administration has doubled since the Bloxham Final Report was drafted.[84] The SAR cases to date have tested the effectiveness of the CASS 7A rules and their interaction with the SAR regulations and underlying insolvency law, and have shaped several resulting reviews. The CASS sourcebook has undergone comprehensive development

81 See paragraph 5.30 of the Bloxham Interim Report dated April 2013.

82 Including for example section 350 FSMA 2000 (disclosure by HMRC) and the Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 (SI 2001/2188) (relating to disclosure of confidential information).

83 12 firms have now entered a SAR administration (see Annex 2).

84 12 firms have now entered a SAR administration (see Annex 2).

through CP13/5 and PS14/9 and consideration of SAR failures was key in formulating the changes introduced. Should future SAR cases arise, they will provide further opportunities to identify additional improvements.

5.43 We recognise the benefits of learning from previous failures, as well as from planning and collaborating before such events occur. Examining the CASS and SAR regimes against real cases has provided an opportunity for review, and meant that hypothetical test cases are not currently needed.

Annex 1
List of questions

Q1: Do you agree with our proposed mechanism for the transfer of the CMP? If not, please provide reasons and suggestions as to how we could approach this differently.

Q2: Do you consider a partial transfer of the CMP a desirable outcome even though it may mean that some clients suffer a greater share of any shortfall? If yes, please outline how this could operate in practice, and any safeguards we could consider.

Q3: Do you agree with our proposal to codify the transfer of custody assets including partial transfers? If not, please provide reasons why, and suggestions as to how we could approach this differently.

Q4: Do you agree with a hard bar date for client money claims? If not, please provide reasons why and suggest alternative measures.

Q5: Do you agree with the process we have set out above setting minimum contact requirements before a hard bar date becomes effective? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q6: Do you agree that the Hindsight Principle should be applied to cleared open margined transactions? What potential issues might arise if this is introduced?

Q7: Do you consider that there may be other transactions to which the Hindsight Principle should be applied apart from cleared open margined transactions? If so, please explain why.

Q8: In what ways could a mismatch arise between a client's CME and the CMP?

Q9: Do you consider that contractual provisions or some alternative valuation method should be used either instead of, or in addition to valuation under the Hindsight Principle, and if so, in what circumstances?

Q10: Do you consider that we need to make changes to the statutory trust in CASS 7 (client money rules) to reflect the Treasury proposals set out above? If so, what should such guidance cover?

Q11: Do you consider that additional information about how a product is structured would assist the administrator and the FSCS in the event of a firm's insolvency? If introduced, what should this include and should any exclusions apply?

Q12: Is there any other information that you think would assist in ensuring FSCS compensation payments are made as quickly as possible?

Q13: Do you consider that firms should provide more clarity to clients around whether a firm's activities may or may not be covered by the FSCS?

Q14: Is the client statement the best place to provide this and what should this comprise? If not, how else could firms communicate this information to clients and what barriers exist to doing so?

Q15: Should firms include details of the structure of products and whether they are carrying on designated investment business in relation to a particular product in the CASS RP?

Q16: Do you agree with these proposed additions? Is there any other information that you think should be added to a CASS RP to assist administrators and the FSCS to achieve speedy return or transfer of client assets, and prompt payment of FSCS compensation where due?

Q17: Do you agree that the detailed explanation of client statements would be a proportionate addition to the CASS RP? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q18: Do you agree that clients and administrators should receive the same explanation of client statements? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q19: Do you agree that a firm could provide this explanation in the client statements themselves and/or on its website? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q20: Do you consider that any changes are necessary to either the client money rules or the client money distribution rules to facilitate this proposal?

Q21: Are there any other court decisions that would benefit from codification in the CASS 7A rules? If yes, please explain which and the reasons why this would be the case.

Q22: Do any points in the LBIE judgments require further codification in the CASS 7A rules? If yes, please explain which and the reasons why this would be the case.

Q23: Should firms be encouraged to segregate a prudent margin in respect of administration costs? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q24: What types of data can be standardised to facilitate distribution of the client estate?

Q25: Which of the above proposed options for the treatment of interest would be preferable? And how should these be apportioned and paid out?

Q26: Do you agree with our proposed de minimis values? If not, please provide reasons why and suggest alternative values.

Q27: Do you agree with our proposed treatment of unclaimed client monies? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q28: Do you consider that an equivalent provision for unclaimed assets would be beneficial? If not, please provide reasons why, and any suggestions as to how we could approach this differently.

Q29: Do you agree with the proposed treatment of de minimis client money entitlements? What minimum steps are proportionate and how should these be tiered?

Q30: **Should this proposed rule include claimed de minimis balances where these are uneconomic to distribute and if so, what minimum level should this be set at?**

Q31: **Should the FCA consider introducing distribution rules within CASS for custody assets? If so, what provisions should these contain?**

Annex 2
SAR insolvencies to date

SAR Administrations to date

SAR Firm Insolvency	Special Administrator	Date appointed
LBIE – (Non-SAR failure, for comparison)	PwC	15 September 2008
MF Global UK Ltd http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Pages/mfglobaluk.aspx	KPMG	31 October 2011
Pritchards Stockbokers Ltd: http://www.mazars.co.uk/Home/Our-Services/Financial-Advisory-Services/Restructuring-services/Pritchard-Stockbrokers-Ltd	Mazars	9 March 2012
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