

Email: cassgeneral@fsa.gov.uk



30 November 2012

Dear CF10a,

Unbreakable Client Money Term Deposits

I write following your firm's responses to a survey issued by the FSA on the use of term deposits for the placement of client money in August 2012.

The survey was issued because the FSA is concerned about the use of term deposits for the placement of client money, where the investment firm placing the deposit has no contractual ability to request the return of the monies prior to the end of the agreed term (an 'unbreakable client money term deposit').

This introduces two potential risks to clients. Firstly, we are concerned that it prevents investment firms from reacting to market developments if a deposit taker or credit institution where such a term deposit has been placed encounters financial difficulties, and ultimately becomes insolvent (a possible secondary pooling event as defined by CASS 7A.3). We expect investment firms to monitor the counterparties they use for the placement of client monies on an on-going basis, and to react to any adverse intelligence (for example a credit rating downgrade meaning a counterparty no longer meets a firm's internal credit policy). However, where firms use unbreakable client money term deposits, they do not have the flexibility to react and move client monies to an alternative counterparty. In a secondary pooling event, unless the investment firm chooses to make good using its own funds, client monies held in a deposit taker in a secondary pooling event are a loss to the client money estate.

Secondly, on the failure of the investment firm placing the deposits (a primary pooling event as defined by CASS 7A.2) the duration of any unbreakable client money term deposits may create a minimum delay in the process of the Insolvency Practitioner distributing client money to clients through the administration of the firm.

Similar concerns arise where firms are placing their client money in 'notice accounts', that is, accounts where you need to give a period of notice prior to withdrawing funds.

Where unbreakable client money term deposits are placed on a pooled basis (i.e. without reference to a specific client) then in principle *all* clients of the firm share in any loss resulting from a secondary pooling event, or are subjected to any delay resulting from a primary pooling event.

The follow-up work we have conducted since issuing the survey highlighted two broad approaches to the use of unbreakable client money term deposits. A number of firms use such deposits at their own discretion. Their terms of business with clients generally allow for this, but the decision as to whether or not to use an unbreakable client money term deposit, to what extent and on what terms – is a decision for the firm alone.

The FSA is of the view that to operate unbreakable client money term deposits where clients are not involved directly in the decision-making around these places all clients at unacceptable risk. This practice may also be in contravention of the conduct of business rules, notably COBS 2.2.1R.

The second approach we identified is firms placing unbreakable client money term deposits on the instruction, or with the express consent, of clients. In principle such an approach allows clients to consider the credit risk of the counterparty proposed, and the terms of the deposit – notably duration, the ability to recall monies and under what circumstances. However, this practice may still introduce a delay in a primary pooling event that could affect all clients, not just those who have decided to use unbreakable client money term deposits (this is because all client monies are pooled in a primary pooling event, regardless of any specific designations per CASS 7A.2.1 G).

Where firms are adopting the second approach, we are interested in how they are considering risks to clients in a primary pooling event. In particular our follow up work suggests that these deposits tend to be placed on a designated basis, with each unbreakable client money term deposit referencing a specific client. If this is the case, we wish to understand better why investment firms are placing term deposits under the CASS 7 rules at all, rather than facilitating term deposits placed in the client's own name and/or using a mandate under CASS 8. This would in principle achieve a similar economic effect for the client, but remove such deposits from the client money regime, and thus avoid the risks described above.

What do we want you to do?

You have been sent this letter because your survey response indicates that your firm uses unbreakable client money term deposits. Accordingly:

- Please review your policies and procedures for client money and confirm whether the use of unbreakable client money term deposits is permitted under these.
- Please confirm whether you have any unbreakable client money term deposits placed in the market as at the date of this letter. If so please provide the value and maturity date of each of these.

- If you do use (or your policies and procedures allow you to use) unbreakable client money term deposits, please confirm whether these are placed at the discretion of the firm, or on the instruction, or with the express consent, of clients.
- Please confirm whether unbreakable client money term deposits are placed on a pooled basis, on a designated basis, or on a combination of the two.

The FSA's Client Assets unit will review this information alongside normal supervisory contacts. There are two primary areas of risk we will focus on (as well as considering any related conduct concerns) and will want to discuss with you:

- As explained, the FSA is of the view that placing client money out in unbreakable term deposits, or in notice accounts, without the instruction or express consent of a client places all clients at unacceptable risk. Accordingly we expect your firm to cease placing new unbreakable client money deposits, and give notice on all notice accounts, from the date of this letter. If you wish to continue to use unbreakable client money term deposits or notice accounts in this manner, please outline why you believe this to be appropriate, bearing in mind the risks described above and your obligations under the FSA's Principles for Business, notably Principles 10, 7 and 8.
- If you are placing unbreakable client money term deposits or using notice accounts on the instruction, or with the express consent, of clients; please explain why you believe this is appropriate bearing in mind the risks described above, and why these deposits are not placed in the client's own name.

Please send your responses to the above points by email (with any supporting documents you feel appropriate) to cassgeneral@fsa.gov.uk. Please copy in your normal supervisory contact, where you have one. We will consider these and be in contact to discuss any next steps.

Please send in your response by close of business on December 14. Once we have your responses we will consider what further action, if any, is appropriate.

Kind regards

Richard Sutcliffe

Head of the Client Assets Unit, the Financial Services Authority