

PS 11/5

Financial Services Authority

Auditor's client assets report

March 2011

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This Policy Statement reports on the main issues arising from Consultation Paper 10/20 (*Improving the auditor's report on client assets*) and publishes final rules.

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Copies of this Policy Statement are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.

Acronyms used in this paper

AADB	Accountancy and Actuarial Discipline Board
AAF 01/06	Audit and Assurance Faculty technical release 01/06
APB	Auditing Practices Board
CASS	Client Assets sourcebook
CBA	Cost benefit analysis
CMAR	Client Money and Asset Return
CP	Consultation Paper
DP	Discussion Paper
FCA	Financial Conduct Authority
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act 2000
LBIE	Lehman Brothers International (Europe)
PRA	Prudential Regulation Authority
PS	Policy Statement
SAS 70	Statement on Auditing Standards No. 70: Service Organisations; issued by the Auditing Standards Board of the American Institute of Certified Public Accountants
SUP	Supervision manual
the Treasury	Her Majesty's Treasury

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Overview

Introduction

- 1.1 In Consultation Paper (CP) 10/20 *Improving the auditor's report on client assets*, published in September 2010, we set out the actions we are undertaking to improve the quality and consistency of the auditor's client assets report, and sought views on a number of policy proposals for Handbook amendments.¹
- 1.2 More specifically, the policy proposals aimed to:
- confirm and clarify the standards required for the auditor's client assets report;
 - increase and make consistent the information provided within the auditor's report to enhance its supervisory value; and
 - improve a firm's governance oversight of both its auditors and compliance with the Client Assets sourcebook (CASS).
- 1.3 The consultation period closed on 31 December 2010. We received 20 responses from authorised firms, audit firms, industry associations and auditing supervisory bodies. This Policy Statement (PS) summarises the comments we received on our proposals alongside our response. In the Appendix of this PS we include the made Handbook text.

Background

- 1.4 As we set out in the CP, we had partly relied on external independent assurance to gain comfort that regulated firms have systems adequate to enable them to comply with the client assets regime. However, following a review of auditor's client assets reports, we discovered material failings and weaknesses in a number of reports received.

¹ In previous publications we have referred to the auditor's client assets report as required under SUP 3.10 as the 'auditor's report on client assets'. For clarification and the purposes of this Policy Statement, this document refers to the report as the 'auditor's client assets report' or the 'auditor's report'.

- 1.5 Due to the nature and number of issues identified, we concluded that the failings are not localised to one or a limited number of auditors, but rather indicate a general failure by auditors to apply our requirements relating to client assets effectively, and a need to take steps to improve the quality of auditor's client assets reports.
- 1.6 We have set up a specialist Client Assets Unit with the aim of strengthening the regulation of client assets. As part of this initiative, we took a number of steps to make the auditor's reporting more effective. In the CP, we set out a summary of the specific actions taken to date, and in Chapter 2 of this PS we provide an update.
- 1.7 We intend to supplement these actions with the proposals in the CP to amend our Handbook. In consultation, the majority of responses received were supportive of all our policy proposals. In some instances though, we received suggestions to modify our proposed Handbook amendments and will implement these where they are consistent with our policy intentions. Subject to these instances, we plan to implement all the policy proposals contained within the CP, specifically:
- clarify our expectations by explicitly setting out our requirements for a reasonable assurance report where the firm is holding client money and/or assets, and for a limited assurance report where the firm claims not to hold client money and/or assets;
 - provide guidance to make clear that we expect the auditor's client assets report to comply with applicable auditing standards and guidance promulgated by the relevant auditing standard setting bodies, such as the Auditing Practices Board (APB);
 - stipulate a template to be used for the auditor's report;
 - require the auditor's report to be signed by the individual (in their own name) in the audit firm with primary responsibility for the report;
 - require the auditors to prepare a separate template schedule identifying the CASS rule breaches noted during the period covered by the auditor's report;
 - set out our expectations that a firm is to provide its comments in the auditor's client assets report on actions taken and/or mitigating factors (if any) associated with the breaches identified in the template schedule;
 - require firms' governing bodies to review the findings of the auditor's client assets report;
 - bring the Mandates rules (CASS 8) back within the scope of the auditor's client assets report;
 - simplify (without amending policy) our existing rules, contained within Chapter 3 of the Supervision manual (SUP 3.1), which stipulate the categories of firms that are required to obtain an auditor's client assets report; and
 - require auditors to deliver reports on client assets within four months from the end of the reporting period.

- 1.8** However, based on feedback we received on the implementation deadline, we have decided to extend the transitional period before the proposed rules will come into full force. In accordance with the made Handbook Instrument (see Appendix 1), the new requirements will come into force on 1 June 2011, but auditors and firms have the option not to apply these requirements to an auditor's client assets report with a period that ends on or before 29 September 2011. Auditor's client assets reports with periods ending 30 September 2011 and onwards will need to meet our new requirements.
- 1.9** The made Handbook Instrument (see Appendix 1) does not differ significantly from the consultative draft. In Chapter 3 of this PS we provide a summary of the feedback we received from respondents to each of the questions we raised in the CP, followed by our response.
- 1.10** The APB is undertaking a review of the guidance it provides to auditors regarding reporting on client assets, to consider how this might be developed in light of our concerns about auditors' work in this area and to consult on changes considered appropriate. We welcome this, and plan to continue our dialogue with the APB as it undertakes this review. In order to best inform this work, we will also be sharing with the APB a summary of the consultation feedback and our own findings.
- 1.11** The APB has communicated to us that it has established a Client Assets Sub-committee, to steer this project and to make recommendations to the APB. The APB has also formed an advisory group of experts to assist its staff in conducting the review and developing proposals for any changes considered appropriate. We will take part in meetings with both the Client Asset Sub-committee and the advisory group of experts.

Cost benefit analysis

- 1.12** We have received some comments relevant to the cost benefit analysis (CBA) to which we have responded in the relevant sections below. None of the comments received raise any issues concerning the validity of the CBA we published in the CP and therefore do not require any change in our analysis.

Work undertaken in 2010/2011

- 1.13** We established the Client Asset Unit last year to improve compliance in this area, pooling together expertise to meet our aim of improving the protection of client money and custody assets (client assets).² We continue to increase our scrutiny of firms holding client assets through more intensive, intrusive supervision and improved intelligence gathering.

² For more information about the Unit's work last year, please see: www.fsa.gov.uk/Pages/About/Who/Management/Teams_1/cass/cab/index.shtml

- 1.14** The monthly Client Money and Assets Return (CMAR) for CASS large and medium firms³ will begin in June 2011. The CMAR will provide us with an overview of UK investment firms' CASS holdings and firms' CASS positions, enabling us to make regulatory interventions on a timely, firm-specific or sector-wide basis. We have proposed⁴ that CASS small firms will not yet be required to complete the CMAR; instead they will be required to notify us of their highest client money balance and value of client assets in July 2011. This notification requirement for CASS small firms, along with the CMAR for CASS medium and large firms, will allow us to monitor effectively key trends and help us identify CASS risks.
- 1.15** We have sought to improve the CASS governance oversight of firms holding client assets from investment business through the introduction of the new Approved Persons function – CASS operational oversight function (CF10a). By 1 October 2011 CASS medium and large firms must have obtained FSA approval for an individual to hold the firm's CASS operational oversight function (CF10a).⁵ This function will improve senior management oversight and further focus firms on their CASS obligations. The application process will open from 1 May 2011.
- 1.16** More specific information on both of these initiatives and others impacting on firms doing investment business can be found in Policy Statement 10/16: *Client Assets Sourcebook (Enhancements) Instrument 2010 Feedback on CP10/9 and made rules*; and Consultation Paper 11/4: *The Client Money and Assets Return (CMAR): Operational Implementation*.

Future work

- 1.17** The protection of client assets will remain a regulatory priority. We will continue our intensive and intrusive approach to identify and mitigate CASS risks. We will continue to monitor proceedings of the Lehman Brothers International (Europe) (LBIE) Supreme Court client money appeal and we will consider our policy response to the issues raised. We plan to continue to develop our policy initiatives on a number of areas to ensure that the CASS regime delivers the desired level of client protection, financial stability and market confidence. Firms can expect future policy work to focus upon: a review of CASS 5 client money – insurance mediation activity; the establishment of a CASS Resolution Pack as part of the FSA's wider review of recovery resolution plans; and, proposals to create a new client asset fee-block.

³ Size stratified according to the value of money and other assets the firm holds. See PS10/16 Chapter 5 for detail.

⁴ CP11/4: *The Client Money and Assets Return (CMAR): Operational Implementation*.

⁵ Details can be found in PS10/16: *Client Assets Sourcebook (Enhancements) Instrument 2010 Feedback on CP10/9 and made rules*.

Who should read this Policy Statement?

- 1.18 This PS will be of particular interest to:
- regulated firms, particularly those firms that hold and control client money and/or assets, and those firms which do not hold client money and assets but carry on designated investment business;
 - regulated firms' trade bodies;
 - external auditors and their professional bodies; and
 - auditing standard setting bodies.

Next steps

- 1.19 The made rules attached in Appendix 1 will come into force on 1 June 2011. These rules will affect both regulated firms and their auditors. However, there will be transitional provisions ending 29 September 2011, during which time firms and their auditors have the option of not applying the new rules. Thereafter, auditor's client assets reports with a period ending 30 September 2011 and onwards will be required to follow the new rules.

CONSUMERS

The measures set out in this paper enhance the CASS regime, which is designed to give an appropriate level of consumer protection and market confidence. However, we consider the proposals to be most relevant to regulated firms and their auditors.

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Enhancing the auditor's contribution

- 2.1 Since we established the Client Assets Unit, we have continued our supervisory review of firms' CASS compliance. These reviews are risk focused: firms are selected based on various inputs including intelligence received from firms, firms' general supervisory reviews, and our knowledge of sector-specific issues. We also use the auditor's client assets report to help us understand what issues firms faced in the reporting period.
- 2.2 We have recently noted evidence of improvements in the quality and consistency in some auditor's client assets reports. These improvements include more frequent auditor identification of CASS issues in regulated firms, greater detail conveyed on the issues identified, and in some instances, detail from the firm on how they have mitigated the issues reported.
- 2.3 We welcome these improvements, which are consistent with the actions we have taken in response to evidence of past failings and the various policy proposals set out in the CP, which we are implementing as set out in this PS.
- 2.4 Nevertheless, we continue to observe some auditor's reports that contain the material failings of the type identified in the CP. In these instances, where appropriate, we have referred the auditor to its supervisory body and the Accountancy and Actuarial Discipline Board (AADB). We will continue this practice in the future.
- 2.5 On 10 March 2011, we published our Feedback Statement on Discussion Paper (DP)10/3 *Enhancing the auditor's contribution to prudential regulation*. The Feedback Statement summarises and responds to the responses we received to the questions raised in DP10/3. The Feedback Statement is organised around four main themes: enhanced dialogue with auditors; professional scepticism and firm's disclosures; scope of auditors' reporting; and the range of powers of the FSA and the Financial Reporting Council (FRC). The Feedback Statement also indicates the various actions we and the FRC have taken since the publication of DP10/3 and discusses our next steps and expectations for the future.

- 2.6 Furthermore, in September 2010, the Bank of England set up a joint Working Group with the FSA to establish a framework for improving the relationship and information flows between the audit profession and supervisors. In February 2011, we published for consultation as guidance a draft code designed to enhance dialogue between auditors and supervisors.⁶ The aim of the code is to improve audit effectiveness and ensure that supervisors are better informed about, and able to challenge, the firms they regulate. The code's proposals are designed to enhance the ability of the FSA to scrutinise specific accounting practices and related judgements in order to understand fully their implications and to highlight emerging problems. This work underscores the importance of the auditor in the FSA's regulatory regime.
- 2.7 In February 2011, Her Majesty's Treasury (the Treasury) published its second consultation document on regulatory reform: *A new approach to financial regulation: building a stronger system*.⁷ The document outlines the next stage of the government's thinking, based on the proposals of an earlier July 2010 consultation and continuing policy development carried out by the Treasury working with the FSA and Bank of England.
- 2.8 As a part of this consultation, the Treasury has proposed that both the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) should be given rule-making powers in relation to actuaries and auditors and that each institution should retain the power to disqualify actuaries or auditors that fail to comply with these rules or any duty imposed on them under the Financial Services and Markets Act 2000 (FSMA). The consultation also proposes making it clear that these institutions will have the power to disqualify any individual professional within those firms.
- 2.9 We welcome the improvements we have already observed and the other policy initiatives being implemented. We will continue to work with the audit profession to improve the effectiveness and value received from auditors' work.

6 FSA (2011), *Code of Practice for the relationship between the external auditor and the supervisor* Consultation Paper, February 2011. Available at: www.fsa.gov.uk/pages/Library/Policy/guidance_consultations/2011/11_05.shtml

7 The Treasury (2011), *A new approach to financial regulation: building a stronger system* Consultation Paper, February 2011, paragraphs 5.94-5.95.

3

Improving the auditor's client assets report

Scope

- 3.1** In this chapter we set out the responses we received in consultation, and the rules we are implementing which amend Chapter 3 of the Supervision manual (SUP 3). The rules aim to:
- confirm and clarify the standards required for the auditor's client assets report;
 - increase and make consistent the information provided within the auditor's report to enhance its supervisory value; and
 - improve firms' governance oversight of both their auditors and their compliance with the Client Assets sourcebook (CASS).
- 3.2** The proposals in this chapter will apply to the auditor's client assets report required in SUP 3, and all firms and their external auditors that are currently subject to those requirements.⁸
- 3.3** As stated in CP10/20, our proposals to amend SUP 3 do not affect the requirements elsewhere in CASS for written confirmation from a firm's auditor. CASS requires the firm to provide us with written confirmation from the firm's auditor on the firm's systems and controls when it plans to adopt either a different method to reconciliations or the alternative approach to segregation from the standard method and approach set out in CASS for firms who hold client money and/or assets.⁹ Firms which hold client money and/or assets are reminded that, before they adopt a different method to reconciliations or the alternative approach to segregation, they are required to provide the FSA separate written confirmations from their auditor in accordance with the relevant CASS rules. The periodic auditor's client assets report (SUP 3.10) does not fulfil this obligation.

⁸ These proposals will apply to auditors engaged by regulated firms to provide the auditor's client assets report. A firm is not required to engage the same firm of auditors to provide both the auditor's client assets report and the statutory audit of its financial statements.

⁹ For example, a written confirmation from a firm's auditor is required under CASS when use is made of: a non-statutory client money trust (CASS 5.4.4R(2)); an alternative reconciliation method for custody assets (CASS 6.5.5R); or, the alternative approach for segregation of client money (CASS 7.4.15R).

- 3.4 Some of the feedback we received from respondents related to auditors' testing methodology – such as the use of control assessment reports by auditors to assess a regulated firm's outsourcing arrangements. Such matters are outside the scope of the rules and therefore, where relevant, we have provided a summary of these comments to the APB to consider as part of its review of the guidance notes and standards it provides auditors on client assets reporting.

Clarifying our expectations regarding the type of report and the applicability of auditing standards

- 3.5 In CP10/20 we asked:

Q1: Do you agree that we should stipulate the requirements for a reasonable assurance report where a firm is holding client money and/or assets and a limited assurance report where a firm claims not to hold client money and/or assets? If not, why not?

- 3.6 The majority of respondents supported this proposal, describing it as 'both risk-based and proportionate' and a 'cost-effective and sensible approach'.
- 3.7 However, a few respondents disagreed with the scope of the auditor's client assets report and/or argued that an alternative type of auditor's engagement should be adopted. Their suggestions included establishing a minimum threshold based on the amount of client money a firm holds at which an auditor's report would be required, or replacing the current engagement with 'an agreed upon procedure' or AAF 01/06¹⁰ or SAS 70¹¹ assurance type of reporting.
- 3.8 In addition, some of the responses stated that additional guidance by the FSA would be beneficial to auditors. This included a better description of what constitutes 'adequate systems' and an explanation of the relevance of 'materiality' to the auditor's opinions and suggestions. A few responses suggested that there was insufficient industry guidance on limited assurance engagements.

Our response

Agreed upon procedures or AAF 01/06 or SAS 70 style reports could potentially provide greater depth on the controls a particular firm has in place and the testing procedure an auditor has undertaken before reaching his conclusion. We recognise that such reports can provide value in specific occurrences where the receiving

¹⁰ Audit and Assurance Faculty technical release 01/06.

¹¹ Statement on Auditing Standards No. 70: Service Organisations; issued by the Auditing Standards Board of the American Institute of Certified Public Accountants.

party requires a more detailed understanding of the firm's controls and the specific testing undertaken by the auditor. However, nothing yet suggested has led us to conclude that this type of assurance report is better suited for our needs. The auditor's client assets report is designed to give us an independent professional judgement on the state of a firm's compliance with the detailed requirements of CASS. This report is provided for a large number of firms, of varying sizes and complexity, and its current format results in a succinct report that gives us notice of the exceptions only. Therefore, we believe that with the changes we are implementing now, the current reporting format remains fit for purpose.

For certain types of firms that carry on investment business, we recognise that there is a risk that these firms could inadvertently hold client money and/or custody assets when they claim not to hold them. In these circumstances the firm may not have the relevant permissions and/or not have appropriate systems to enable them to comply with the applicable client assets rules. We therefore require the auditors for these types of firms to provide us with confirmation that nothing has come to their attention that causes the auditor to believe that the firm did hold client assets.

The requests we received for further guidance relate to matters concerning an auditor's professional judgement with regard to the relevant reporting standard. As a result, we think that the auditing supervisory bodies and, in particular, the APB, will be better placed to advise. We are providing the APB with a summary of the consultation feedback we received in order to facilitate its review of the relevant guidance it provides to auditors on client assets reporting.

Based on this, we will implement our proposals and will continue to work with the APB to improve the professional guidance promulgated that is relevant to the auditor's client assets report.

3.9 In CP10/20 we asked:

Q2: Do you agree that we should set out in guidance that we expect the auditor's report on client assets to comply with applicable auditing standards and guidance promulgated by the relevant auditing standard setting bodies, specifically the APB? If not, why not?

3.10 The majority of respondents were supportive of our proposal to provide guidance making it clear that we expect the auditor's client assets report to comply with applicable auditing standards and guidance promulgated by the relevant auditing standard setting bodies, specifically the APB. Many of the responses we received described this proposal as both sensible and appropriate.

- 3.11 Nevertheless, a few respondents thought our proposed guidance placed too much reliance on the APB's standards and guidance. Their disagreement was based on a preference for a different type of auditor's engagement (e.g. AAF 01/06 or SAS 70) rather than perceived deficiencies in the quality of industry guidance available for limited assurance engagements.
- 3.12 Some responses also suggested that the current wording in SUP 3.10.4R gave an impression that the only auditing standards under which an auditor must act were those from the APB. (Our policy stated we expect a UK firm to consider the standard and guidance promulgated by the APB; however, where relevant, any other applicable standards and guidance should also be considered).
- 3.13 One response suggested that, in defining both reasonable assurance engagement and limited assurance engagement with reference to the definitions promulgated by the APB, we should include a specific reference to the APB's 'Glossary of terms' in its publication: *Standards and Guidance for Auditors*.

Our response

We do not intend to provide guidance that specifies the audit process that an auditor should undertake when undertaking to provide an auditor's client assets report. We do not regulate auditing and assurance reporting services. Therefore we look to the auditing profession's standard setting bodies to provide the relevant standards and guidance. In the UK, this is the APB.

Nevertheless, we agree that our guidance should not require an auditor only to follow the APB's standards and guidance in preparing the client assets report. In addition, we acknowledge that there may be other standards and guidance also relevant to an auditor's undertaking that could be considered (e.g. an auditor acting in a jurisdiction outside of the UK).

We have also taken note of the feedback some responses provide on the amount and quality of industry guidance available to practitioners acting in a limited assurance engagement. In spite of this, we note that we have consistently required an auditor to report to us when a firm claims not to hold or control client money and/or custody assets. Furthermore, we do not think it is appropriate for the FSA to be prescribing the methodology with which an auditor should reach his/her professional opinion or conclusion. We reiterate that we expect guidance on this matter to come from the auditing profession's own standard setting bodies.

We will maintain a close watch over the continued development of industry guidance relevant to the auditor's client assets report. We intend to assist the work the APB is carrying out in reviewing this subject.

Subject to minor modifications to reflect feedback received as set out above, we will implement this proposal as consulted upon.

Improving the transparency and consistency of the auditor's client assets reports

3.14 In CP10/20 we asked:

Q3: Do you agree with the proposals for our rules to stipulate the template to be used for the format of the auditor's opinion? Do you foresee any difficulties auditors may face in using the proposed template provided in Annex 3?

3.15 Respondents were broadly supportive of this proposal and most agreed that it would improve the consistency and quality of the auditor's client assets report.

3.16 Five responses though were critical of the template, suggesting that it was too inflexible. These responses generally argued that the auditor needs to retain a greater ability to tailor the wording in the report. One response pointed out that the production of a limited or reasonable assurance report requires a level of judgement and, in utilising that judgement, auditors will want to tailor the wording of the report to suit specific circumstances. Another response suggested it would be vital to ensure the auditor's client assets report is able to meet the needs of individual circumstances. Another response suggested we provide further flexibility by requiring auditors to comply with the template as drafted 'unless specific circumstances dictate a slightly different approach, in which case, a reason for the variation should be clearly specified.' None of the responses described in what specific situations the proposed template would be inadequate.

3.17 Many of the responses also provided technical suggestions for improving the terminology and format of our proposed reporting template.

Our response

We agree with a variety of the suggestions received to improve the terminology and format of our proposed reporting template. Each of the changes we intend to implement are drafting suggestions which should better reflect our policy objectives and increase the ease with which an auditor will be able to make use of the required template.

Some of the suggested changes we have rejected include: altering the template headings so as to distinguish between an auditor's 'opinions' and 'conclusions' when describing the auditor's statements under either a *reasonable assurance engagement* or *limited assurance engagement* respectively; incorporating the firm as an addressee to the report; and, providing for additional paragraphs which allow the auditor to articulate its liability or limit the reliance we can place on the validity of the auditor's opinion.

The auditor's client assets report is a private report between the auditor and the FSA, which we also expect the firm (who engaged the auditor) to have reviewed

and considered. For this reason, we do not think including additional language in the report which has a bearing on the auditor's liability to be necessary or beneficial. We believe the template provided in SUP 3 Annex 1R takes sufficient account of the limitations inherent in the opinions the auditor provides and we do not need the auditor to reiterate these further in the text of the report.

Some respondents also questioned whether an auditor provides an 'opinion' or 'conclusion' when acting in a limited assurance engagement. We have observed that industry guidance on this topic utilises both 'conclusion' and 'opinion' terminology. Moreover, we do not believe that the headings used in our reporting template alter the work an auditor is expected to carry out or change the consequences of any statement an auditor provides in the same template. As a result, we have not amended our template to refer separately to either an auditor's opinion or conclusion. Whether acting in a reasonable assurance engagement or a limited assurance engagement, it suits our needs to simply refer in the auditor's client assets report to the auditor's opinion.

We do not consider the auditor's client assets report as proposed to be insufficiently flexible. The proposed reporting template largely reflects the matters we require the auditor to give an opinion on. Moreover, the auditor will retain the ability to notify us when they are unable to provide an opinion.

To allow an auditor to deviate from the reporting template beyond what is already allowed would in our view result in inconsistency in reporting formats. This would defeat our desire to standardise the auditor's client assets report, in order to facilitate our ability to monitor thematic trends and better implement our supervisory regime for CASS compliance. However, we will continue to monitor the operation of the regime and invite auditors to contact us if they feel they cannot make use of the reporting template as provided on a case-by-case basis.

Based on this, we will implement this proposal as consulted subject to some minor technical improvements in the reporting template.

3.18 In CP10/20 we asked:

Q4: Do you agree with the proposals to require the auditor's opinion to be signed by the individual with primary responsibility for the report within the audit firm?

3.19 All respondents supported this requirement. They generally agreed that this proposal should increase accountability and as a result improve the quality of the report the FSA receives.

3.20 A few responses asked us to clarify that the identification of an individual auditor and the provision of a personal signature should not increase the auditor's personal liability. Two of the responses requested we adopt language on the auditor's liability similar to that found in section 504(3) of the Companies Act 2006.

- 3.21 One response also asked us to clarify what an auditing firm should do if the audit partner responsible for the report is absent around the due date of the report.

Our response

We do not think it necessary or appropriate for us expressly to include language similar to that found in the Companies Act 2006 on auditor liability. We recognise that the proposal will increase an auditor's accountability to the FSA. However, this proposal will not affect the auditor's legal liability or the engagement relationship between the audit firm and the regulated firm (which should be determined by the engagement agreements between the firm and its auditor).

We will not comment on the appropriate actions an audit firm should take in the event that the individual with primary responsibility for the report within the audit firm is absent around the due date of the report. We have no reason to think that an audit firm would treat this situation any differently than if the relevant individual was absent when a report under the Companies Act 2006 becomes due. We will share this request for clarification with the APB and likewise suggest concerned audit firms contact their supervisory bodies for advice as necessary.

We will implement our proposal to require the auditor's client assets report to be signed with the name of the individual with primary responsibility for the report within the audit firm as consulted upon with no changes.

- 3.22 In CP10/20 we asked:

Q5: Do you agree that auditors should complete a separate schedule listing the breaches of CASS identified in the firm during the period subject to the auditor's report? Do you foresee any difficulties the auditors may face using the proposed template provided in Annex 4?

- 3.23 The majority of respondents supported this proposal. The responses generally agreed that this proposal would assist the FSA in carrying out its regulatory responsibilities. This proposal would allow us to undertake baseline monitoring across firms holding client assets and identify when the need may arise to undertake a thematic review of a specific CASS policy based on the number of firms breaching a particular rule.
- 3.24 However, six responses were critical of this proposal, arguing that the breaches reported to the FSA should be only those which are material to opining on the adequacy of a firm's systems and controls and/or that the auditor's report should as a matter of policy only contain breaches the auditor identifies. The responses in this latter category requested that

any breaches a firm identifies be reported to the FSA through a different medium, such as the Client Money and Asset Return (CMAR) or in a separate letter from the firm.

- 3.25 One response also considered our drafting in SUP 3.10.9AR and requested that we clarify whether the rule breaches identified are to be only those found in CASS.

Our response

We understand that not every CASS rule breach may be material to an auditor's opinion. However, we are requiring the auditor in the template provided to record any breach of CASS identified by the auditor (e.g. through sample testing), or notified to the auditor by the firm or any other party (e.g. the firm's breaches register). The record of these breaches (along with associated contextual information) will permit us to undertake baseline monitoring across firms holding client money and assets. This will also allow us to identify when a thematic review might be necessary based on the number of firms breaching a particular rule. If we were to require the reporting of only certain rule breaches (e.g. beyond a materiality threshold), this would not give us the comprehensive intelligence we seek to better understand firm behaviour, identify industry trends, and to compare the effectiveness of varied approaches to establishing and maintaining adequate systems and controls.

For these reasons, we do not intend to establish a threshold below which certain CASS rule breaches need not be reported. However, where appropriate (as set out in the example provided in Annex 4 of the CP), we expect auditors to report a single entry in the reporting template with an explanation of the frequency of a breach where there are repeated breaches and the context of those breaches is similar, therefore reducing the amount of duplication in the report.

Likewise, we do not think it is appropriate for us to rely only on regulated firms to report to us on CASS rule breaches. We already require regulated firms to report to us (in a timely manner) if they believe they have breached certain CASS rules. However, the requirement on auditors is to provide us on an annual basis an independent assessment of the breaches that have occurred with the firm.

To clarify, though we are requiring the auditor to provide a list of CASS breaches identified with the firm during a given period, it remains the firm's responsibility to maintain systems adequate to enable it to comply with the CASS rules.

We note that only one response requested clarification of whether we intended for the auditor to provide detail on firm breaches of non-CASS rules that they have potentially identified. We confirm that we do not expect the required breaches schedule to contain anything other than identified breaches of CASS. If no CASS breaches have been identified, then we expect the auditor to provide us a statement to that effect in the breaches schedule (part 2 of the auditor's client assets report).

For all of the reasons mentioned, we will implement our proposal to require the auditor to record all identified breaches in the template stipulated as part of the auditor's client assets report.

3.26 In CP10/20 we asked:

Q6: Do you agree that firms should set out their comments on action taken (if any) and/or mitigating factors associated with the breach the auditor has cited?

Do you foresee any difficulties in the firm providing their comments in the proposed template provided in Annex 4?

- 3.27** All of the respondents agreed that, if we proceed with the reporting type and format proposed, we should allow firms to comment on the breaches the auditor cites. The responses suggested this proposal would: assist the FSA in monitoring the remedial actions firms take; increase management awareness of CASS compliance issues and reinforce firm responsibility for the correction of breaches; improve the quality and accuracy of the auditor's client assets report by ensuring that the auditor is fully informed about firm actions; and potentially improve the auditor's relationship with the firm in situations where the auditor disagrees with the firm over its compliance with CASS.
- 3.28** Two respondents questioned whether this was an appropriate medium for communicating information about breaches to the FSA, suggesting that information about the firm's responses to identified breaches may be better suited to a firm's breaches register, the CMAR or a separate letter from the firm.
- 3.29** Finally, many of the responses we received from audit firms discussed the regulated firm's responsibility for providing firm comments and what might happen if the regulated firm provides no, limited or inaccurate commentary.

Our response

Requiring firms to include their comments about identified breaches in the auditor's report provides us with information on the remedial actions (if any) the firm has taken to address the identified breaches. It will also improve communication between the firm and its auditor, improving the quality and accuracy of the auditor's client assets report, and the data generated should increase management awareness of CASS compliance.

We also remind auditors that, if they do not receive from the firm the information prescribed for the auditor's report, they must submit the report without that information with an explanation for its absence. Where the audit firm is aware

that the comments provided by the firm in the auditor's report in relation to the identified breaches are inaccurate or false, the auditor remains subject to FSMA reporting requirements, and its own professional ethics rules and standards.

For all of the reasons mentioned, we will implement our proposal that a firm should be required to provide its comments on the breaches recorded in the auditor's client assets report.

Clarifying the expectations regarding a firm's governing body in relation to its auditor's client assets report

3.30 In CP10/20 we asked:

Q7: Do you agree that we should require the firm's governing body to consider the findings of the auditor's report on client assets?

3.31 Almost all respondents supported our proposals to set out in our rules the requirement for a regulated firm's governing body to consider the findings of the auditor's client assets report.

3.32 Some respondents had concerns that a firm's governing body may not have sufficient time to review the findings before the report is submitted to the FSA. Likewise, another respondent requested we clarify when we would expect the governing body of the firm to review the auditor's findings.

3.33 Three other respondents suggested that, instead of the governing body, an individual could be assigned this responsibility (e.g. the CASS operational oversight function (CF10a)) and queried whether a firm should allow their Board to delegate this responsibility to management or another sub-committee.

Our response

We have not proposed that a firm's governing body be required to review the auditor's client assets report ahead of the report's submission to the FSA. Some firms may prefer that their governing body fully consider the auditor's report before it is submitted to their regulator; however, we are not requiring a firm to do this. We will require the firm's governing body to review the final auditor's client assets report.

Whether or not the governing body considers the auditor's report before it is submitted to the FSA, we expect firms to use the report as a tool to evaluate the effectiveness of the systems it has in place for the purpose of complying with its CASS obligations. This includes ensuring that the report is integrated into the firm's governance oversight framework.

We do not think it would be appropriate for a firm to allow its governing body to delegate responsibility for consideration of the findings in the auditor's client assets report. Our clear policy intention is to ensure that a firm's governing body is aware of any deficiencies in the firm's CASS systems and has an opportunity to assess the effectiveness of any management response.

The feedback received also indicated that we should provide guidance as to when we expect a firm's governing body to review the findings of the final auditor's client assets report. We have indicated in our made rules that this must be done promptly after the firm receives the report.

Based on this, we will implement our proposals subject to the minor adjustments necessary to reflect the feedback we accepted above.

Amending and clarifying the scope and submission requirements

3.34 In CP10/20 we asked:

Q8: Do you agree with the proposal to reintroduce mandates (CASS 8) within the scope of the auditor's report on client assets?

3.35 The vast majority of respondents were supportive of our proposals to re-introduce mandates within the scope of the auditor's client assets report.

3.36 A few respondents seemed unsure whether reporting on the mandates rules should be included in the auditor's opinion when reporting on a firm that did not hold client money and/or custody assets but did hold mandates. Regarding these concerns, two respondents did not agree with the proposal to include reporting on mandates rules within the scope of the auditors' report for insurance intermediaries¹² because, in their experience, the majority of insurance intermediaries do not hold mandates in any way.

3.37 Two respondents noted that firms that do not hold client assets may still have the ability to control client assets that are held by other regulated firms. As the auditors of the other regulated firms that are holding the assets will be required to provide the client assets report, the respondents recommended that reporting on the mandates rules should not be included within the scope of the auditor's client assets report for firms that do not hold client assets in this particular scenario, to avoid duplication of reporting in this area.

3.38 One respondent stated that, from their perspective, the current mandates rules are not sufficiently detailed to provide a framework against which to provide an opinion, and that the mandates rules would need to be amended before introducing an audit requirement.

3.39 Some respondents noted that there could be circumstances in which mandates exist but the firm is outside the scope of the auditor's client assets report, and therefore separate

¹² Firms subject to CASS 5 (Client money: insurance mediation activity).

requirements should be introduced for consistency if it was considered that the risk required it. Conversely, mandates may exist in entities not within the scope of regulation and the question arises as to whether a level playing-field is in the public interest in such circumstances.

Our response

The rules and the controls implemented by firms around mandates are different from the controls relating to the holding of client money and assets. Firms are required to have adequate controls within the firm to prevent the misuse of the authorities granted by the client, and we think the auditor's client assets report gives us a tool to monitor compliance by those firms subject to our regime.

Prior to November 2007 auditors had reported on the mandates rules in their client assets report, and we therefore conclude that our current rules are adequate to enable the auditor to provide an opinion on.

We confirm, in the rules as drafted and consulted upon, the auditor's client assets report will only be required to cover the mandates rules if the firm is actually holding mandates and the firm is subject to a reasonable assurance report because it holds client money or assets (i.e. the auditor will not be required to report on the mandates rules if the firm is not holding client money or assets). However, we will keep this matter under review and take steps accordingly should we identify evidence of material market and regulatory risks.

We will implement our proposal to reintroduce mandates within the scope of the auditor's client assets report as consulted upon and with no changes.

3.40 In CP10/20 asked:

Q9: Do you agree with our proposal to simplify our existing rules, contained within SUP 3.1, which stipulate the firms that are subject to the auditor's report on client assets?

3.41 All respondents were supportive of our proposals to clarify the existing SUP 3.1 rules as set out in CP10/20.

3.42 Two respondents requested further clarification on wording in SUP 3.1.2R specific to individual circumstances. As with any requests received from an authorised firm and/or its auditors, we have provided these respondents with individual guidance.

Our response

We intend to implement our proposed simplifications made to SUP 3.1 as consulted upon subject to minor amendments.

3.43 In CP10/20 we asked:

Q10: Do you agree with our proposals to replace existing guidance with a rule requiring auditors to deliver reports on client assets within four months from the end of the period covered?

3.44 With the exception of two, every respondent agreed with our proposals to replace the existing guidance applicable to most auditors with a rule requiring those auditors to deliver the auditor's client assets report within four months from the end of the period covered.

3.45 One of these two respondents noted that the guidance is helpful but, as guidance, it allows a degree of flexibility for reasonable and legitimate instances where the auditor's client assets report may take longer to produce. The other respondent believed providing additional time would increase the emphasis that management places on taking ownership of the CASS regime in the firm and would also ensure that its comments on the auditor's findings were included in the appropriate timeframe.

3.46 Four other respondents, though agreeing with this proposal, expressed concerns that: delays could arise if a firm's management is not provided with the report with adequate time to include comments; the auditor would not receive the firm's responses in a timely way; or, a firm's governing body would not have the opportunity to review the report before it is submitted the FSA.

3.47 Two respondents requested us to be more precise on what we mean by four months, specifically in the situation where the reporting period end is not at the end of a calendar month, and suggested some minor points for clarification to our draft handbook text.

Our response

The auditor's client assets report is a tool for our supervision of firms' compliance with CASS; it is important that the information it contains is timely in order to facilitate when necessary a prompt response from us. We consider that four months following the period end is a reasonable time by which the auditor can complete their required testing and submit the report.

We have set out the requirement for the auditor to notify us with their reasoning if they are unable to report within the required timeframe.

Our proposals included provisions to require the auditor to provide the report to the firm with adequate time to enable them to include their comments (as

required by our proposals), and also for the auditor to report without the firm's comments if they have not received the firm's comments in time.

To clarify, our requirements for the firm's governing body to review the auditor's client assets report are not captured by the requirement for the auditor to submit the report within four months of the period end. We only require the governing body to review the final auditor's client assets report promptly, which can be before or after the report has been submitted to us.

Finally, we note the responses asking us to clarify more precisely what we mean by 'four months'. We believe that our rules provide a sufficiently clear statement of our expectations without the need for further guidance. By way of example, if the auditor's client asset report relates to a period ending 31 December, we would expect the report to be provided by or on 30 April. If the report relates to a period ending, say, 19 May, we expect a report by or on 19 September.

We intend to implement as consulted our proposal to replace the existing guidance with a rule requiring auditors to deliver their client assets report within four months from the report's period end.

Timing

3.48 In CP10/20 we asked:

Q11: Do you agree with our proposals to have new requirements in place for the auditor's report for the period ending 30 June 2011 and onwards?

3.49 The majority of respondents did not find it unduly burdensome or unreasonable to require auditor's client assets reports with a period ending 30 June 2011 and onwards to comply with our new requirements.

3.50 One respondent highlighted that the June 2011 date would not provide them with adequate time to implement changes to their procedures. Another respondent stated that, while larger audit firms should have the technical resources to make changes quickly, it questioned whether this implementation date was achievable for smaller audit firms.

3.51 A few of the respondents highlighted that the APB would not have improved guidance published before our proposals would come into force. These responses suggested that it could be beneficial to allow more time before our requirements come into force to take account of the APB's timetable for publishing revised guidance on the auditor's client assets report.

Our response

No small audit firm has suggested or otherwise confirmed that it will not be able to adhere to these new requirements for reports with a period ending on or after 30 June 2011. Nevertheless, in light of the responses received, we think it would be reasonable to extend the transitional provisions to require auditors to adhere to these new requirements in auditor's client assets reports with periods ending on or after 30 September 2011. We believe that this will ensure that all sizes of audit firms have sufficient time to incorporate these made rules into their audit procedures and methodology.

We appreciate that the APB is currently considering revising the guidance it provides to auditors in relation to the auditor's client assets report. However, until then, auditors should have regard, where relevant, to existing applicable guidance and standards. The APB's current standards and guidance remain relevant to the auditor's client assets report. Nevertheless, with regard to any changes the APB implements in their revised guidance or standards, we will carefully consider reviewing our own rules and guidance as necessary.

Cost benefit analysis

3.52 In CP10/20 we asked:

Q12: What are your views on the benefits and costs of the proposed policy measures?

- 3.53 None of respondents questioned the validity of the CBA we published in the CP. Only one respondent argued our CBA was incomplete, but they gave us no examples or suggestions on how to improve the CBA.
- 3.54 One respondent noted that auditors are already following recognised industry auditing practices and many of the proposals within the CP are designed to clarify the rules and standardise the reporting format. Therefore they did not expect large increases in fees from auditors. However, they highlighted the risk that some auditors might use this opportunity to increase their fees on the basis of the additional requirements proposed.
- 3.55 A couple of respondents noted that whether there are increased costs will depend upon the reporting framework. They stated that while the proposed format of the auditor's report is similar to the report as historically provided to the FSA, the rule revisions reflect a step change in the regulator's expectations of the scope of the report.
- 3.56 A couple of respondents were concerned that reporting requirements which are duplicative or rely on detailed recording of very minor infractions will result in unnecessary increases in firms' compliance costs.

- 3.57 One respondent noted that we did not include within the CBA the auditor's client assets report for a firm which is subject to the mandates rules, but does not hold client money or assets.
- 3.58 The remaining responses were generally supportive of the benefits and potential efficiencies our proposals should create. One firm also pointed out that the statutory auditor need not be the same auditor who completes the client assets report. They stated that if more audit firms are offered the opportunity to provide this report, the market for these reports would grow, increasing competition and likely lowering the costs of the report.

Our response

We believe that our proposals to require the auditor to report to us CASS rule breaches identified, and for the firm to provide comments in relation to those breaches, will improve the information content of the report and thereby facilitate our monitoring and supervision of firms' compliance with CASS. We appreciate that this will lead to additional costs and this expectation was articulated in our CBA.

Nevertheless, auditors should be aware, as shown in Annex 4 of the CP, we expect auditors to report a single entry in the reporting template with an explanation of the frequency of a breach where there are repeated breaches and where the context of those breaches is similar, therefore reducing the amount of duplication in the report (and costs incurred).

We confirm (as set out in our response to Question 8 above), in accordance with our rules, that an auditor is not expected to provide assurance with respect to the mandates rules when a firm claims not to hold client money or assets. Our CBA reflected this position, only incorporating data about the auditor reports on the mandates rules for firms that do hold client money and/or assets.

The comments we received did not raise any issues concerning the validity of the CBA and, accordingly, we do not believe any change in our analysis is required.

We have also concluded that the minor amendments to our made rules based on the feedback accepted above (reflected above) do not materially impact the CBA as completed.

Annex 1

List of non-confidential respondents

1. Association of Chartered Certified Accountants
2. Association of International Accountants
3. Association of Private Client Investment Managers and Stockbrokers
4. Capita Group
5. Compos Mentis (Training) Ltd.
6. Crashcare UK Ltd.
7. Deloitte LLP
8. Ernst & Young LLP
9. Grant Thornton UK LLP
10. The Institute of Chartered Accounts in England and Wales
11. Investment Management Association
12. International Financial Data Services UK Ltd.
13. KPMG LLP
14. Merit Soft
15. PKF (UK) LLP
16. PricewaterhouseCoopers LLP
17. Rathbones Investment Management Ltd.
18. Solicitors Regulation Authority

In addition to the above, there were two confidential responses to the consultation.

Appendix 1

Final Handbook Instrument

**SUPERVISION MANUAL (AUDITOR'S CLIENT ASSETS REPORT)
(AMENDMENT) INSTRUMENT 2011**

Powers exercised

- A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):
- (1) section 138 (General rule-making power);
 - (2) section 156 (General supplementary powers);
 - (3) section 157(1) (Guidance); and
 - (4) section 340 (Appointment).
- B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

- C. This instrument comes into force on 1 June 2011.

Amendments to the Handbook

- D. The Glossary of definitions is amended in accordance with Annex A to this instrument.
- E. The Supervision manual (SUP) is amended in accordance with Annex B to this instrument.

Citation

- F. This instrument may be cited as the Supervision Manual (Auditor's Client Assets Report) (Amendment) Instrument 2011.

By order of the Board
24 March 2011

Annex A**Amendments to the Glossary of definitions**

Insert the following new definitions in the appropriate alphabetical position. The text is not underlined.

limited assurance engagement a 'limited assurance engagement' as described in the Glossary of terms in the Auditing Practices Board Standards and Guidance for Auditors issued in 2010.

reasonable assurance engagement a 'reasonable assurance engagement' as described in the Glossary of terms in the Auditing Practices Board Standards and Guidance for Auditors issued in 2010.

Annex B

Amendments to the Supervision manual (SUP)

In this Annex, underlining indicates new text and striking through indicates deleted text, unless otherwise stated.

3.1.2 R Applicable sections (see SUP 3.1.1R)

	(1) Category of firm	(2) Sections applicable to the firm	(3) Sections applicable to its auditor
(1)	<i>Authorised professional firm</i> which is required by <i>IPRU(INV)</i> 2.1.2R to comply with chapters 3, 5, 10 or 13 of <i>IPRU(INV)</i> and which has an auditor appointed under or as a result of a statutory provision other than in the Act (Note <u>Notes 1 and 6</u>)	<i>SUP</i> 3.1 - <i>SUP</i> 3.7 ₂ <u><i>SUP</i> 3.11</u>	<i>SUP</i> 3.1, <i>SUP</i> 3.2, <i>SUP</i> 3.8, <i>SUP</i> 3.10
(2)	<i>Authorised professional firm</i> not within (1) to which the <i>custody chapter</i> or <i>client money chapter</i> applies, unless the firm is regulated by The Law Society (England and Wales), The Law Society of Scotland or The Law Society of Northern Ireland (Note 2)	<i>SUP</i> 3.1 - <i>SUP</i> 3.7 ₂ <u><i>SUP</i> 3.11</u>	<i>SUP</i> 3.1, <i>SUP</i> 3.2, <i>SUP</i> 3.8, <i>SUP</i> 3.10
...			
(4)	<i>Bank, building society</i> or <i>dormant account fund operator</i> which in each case carries on <i>designated investment business</i> (Note <u>Notes 2A and 6</u>)	<i>SUP</i> 3.1- <i>SUP</i> 3.7 ₂ <u><i>SUP</i> 3.11</u>	<i>SUP</i> 3.1, <i>SUP</i> 3.2, <i>SUP</i> 3.8, <i>SUP</i> 3.10
...			
(7)	<i>Investment management firm</i> , (other than an <i>exempt CAD firm</i>), <i>personal investment firm</i> (other than a <i>small personal investment firm</i> or <i>exempt CAD firm</i>); or <i>securities and futures firm</i> (other than an <i>exempt CAD firm</i> or an <i>exempt BIPRU commodities firm</i>) which, in each case, has an auditor appointed under or as a result of a statutory provision other than in the Act (Notes 3 and <u>3A 6</u>)	<i>SUP</i> 3.1 - <i>SUP</i> 3.7 ₂ <u><i>SUP</i> 3.11</u>	<i>SUP</i> 3.1, <i>SUP</i> 3.2, <i>SUP</i> 3.8, <i>SUP</i> 3.10
(7A)	<i>Investment management firm</i> (other than an	<i>SUP</i> 3.1 -	<i>SUP</i> 3.1,

	<i>exempt CAD firm), personal investment firm (other than a small personal investment firm or exempt CAD firm); or securities and futures firm (other than an exempt CAD firm or an exempt BIPRU commodities firm) not within (7) to which the custody chapter or client money chapter applies</i>	<i>SUP 3.7, <u>SUP 3.11</u></i>	<i>SUP 3.2, SUP 3.8, SUP 3.10</i>
(7B)	<i>UCITS firm (Note 6)</i>	<i>SUP 3.1 - SUP 3.7, <u>SUP 3.11</u></i>	<i>SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10</i>
(7C)	<i>UK MiFID investment firm, which has an auditor appointed under or as a result of a statutory provision other than in the Act (Note Notes 3B and 6)</i>	<i>SUP 3.1 - 3.7, <u>SUP 3.11</u></i>	<i>SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10</i>
(7D)	<i>Sole trader or partnership that is a UK MiFID investment firm (other than an exempt CAD firm) (Note Notes 3C and 6)</i>	<i>SUP 3.1 - SUP 3.7, <u>SUP 3.11</u></i>	<i>SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10</i>
...			
(10)	<i>Insurance intermediary (other than an exempt insurance intermediary) to which the insurance client money chapter (except for CASS 5.2 (Holding money as agent)) applies (see Note 4)</i>	<i>SUP 3.1 - SUP 3.7, <u>SUP 3.11</u></i>	<i>SUP 3.1, SUP 3.2, SUP 3.8, SUP 3.10</i>
...			
...			
<p>Note 2 = In row (2):</p> <p>(a) The non-directive custody chapter is treated as applying only if (i) the firm safeguards and administers investments in connection with managing investments (other than when acting as trustee) or (ii) it safeguards and administers investments in relation to bonded investments (and, in either case, it has not opted to conduct all business that would fall within the non-directive custody chapter under the MiFID custody chapter).</p> <p>(b) The non-directive client money chapter is treated as applying only if the firm receives or holds client money other than under an arrangement where commission is rebated to the client (and assuming that it has not opted to conduct all business that would fall within the non-directive client money chapter under the MiFID client money chapter);</p> <p>but, if the custody rules or the client money rules above are treated as applying, then SUP 3.10 (Duties of auditors: notification and report on client assets) applies to the whole of the business within the scope of the custody rules or the client</p>			

~~money rules above. [deleted]~~

Note 2A = For this purpose, *designated investment business* does not include either or both:

(a) *dealing* which falls within the exclusion in article 15 of the *Regulated Activities Order* (Absence of holding out etc) (or agreeing to do so); and

(b) *dealing in investments as principal* (or agreeing to do so):

(i) by a *firm* whose *permission to deal in investments as principal* is subject to a *limitation* to the effect that the *firm*, in carrying on this *regulated activity*, is limited to entering into transactions in a manner which, if the *firm* was an *unauthorised person*, would come within article 16 of the *Regulated Activities Order* (Dealing in contractually based investments); and

(ii) in a manner which comes within that *limitation*;

having regard to article 4(4) of the *Regulated Activities Order* (Specified activities: general).

...

~~Note 3A = If the *firm* has elected to comply with the *MiFID custody chapter* or the *MiFID client money chapter* also in respect of its *non MiFID business* then *SUP 3.10* will apply to the whole of the business within the scope of the *MiFID custody chapter* or the *MiFID client money chapter*. [deleted]~~

...

Note 6 = Where *SUP 3.11* applies to a *firm*, and *SUP 3.10* applies to the auditor of that *firm*, those sections apply whether or not that *firm's permission* prevents it from holding *client money* or *custody assets* and whether or not it holds *client money* or *custody assets*.

...

~~Authorised professional firms~~

3.1.8 G ~~This chapter applies to an *authorised professional firm* as set out in rows (1) to (3) of *SUP 3.1.2R*:~~

- ~~(1) a *firm* in row (1) is treated in the same way as its equivalent in row (7);~~
- ~~(2) large parts of this chapter apply to a *firm* in row (2) and its auditor; the report on client assets under *SUP 3.10* (Duties of auditors: notification and report on client assets) must cover compliance for the whole of the business within the scope of whichever of the *custody rules* and the *client money rules* are treated as applying; but there is no requirement for the auditor to prepare a report to the *FSA* on the *firm's* financial statements;~~
- ~~(3) this chapter has limited application to a *firm* in row (3) and its auditor. [deleted]~~

...

3.10 Duties of auditors: notification and report on client assets

Application

3.10.1 R ~~Where this section requires an auditor of a *firm* to report on a *firm's* compliance with *rules*, this section applies to the auditor only to the extent that the *firm* is required to comply with the relevant *rules*. [deleted]~~

...

Client assets report: content

3.10.4 R An auditor of a *firm* must submit a client assets report addressed to the *FSA*, ~~signed in his capacity as auditor~~, which:

- (1) (a) states the matters set out in *SUP* 3.10.5R; ~~or~~ and
- (b) specifies the matters to which *SUP* 3.10.9R and *SUP* 3.10.9AR refer; or
- (2) if the *firm* claims not to hold *client money* or *custody assets*, states whether anything has come to the auditor's attention that causes him to believe that the *firm* held *client money* or *custody assets* during the period covered by the report.

3.10.4A R (1) For the purpose of *SUP* 3.10.4R(1), an auditor must ensure that the report is prepared in accordance with the terms of a *reasonable assurance engagement*.

(2) For the purpose of *SUP* 3.10.4R(2), an auditor must ensure that the report is prepared in accordance with the terms of a *limited assurance engagement*.

3.10.5 R Client assets report

Whether in the auditor's opinion	
(1)	the <i>firm</i> has maintained systems adequate to enable it to comply with the <i>custody rules</i> , the <i>collateral rules</i> and , the <i>client money rules</i> (except <i>CASS</i> 5.2) <u>and the <i>mandate rules</i> throughout the period since the last date as at which a report was made;</u>
(2)	the <i>firm</i> was in compliance with the <i>custody rules</i> , the <i>collateral rules</i> and , the <i>client money rules</i> (except <i>CASS</i> 5.2) <u>and the <i>mandate rules</i>, at the date as at which the report has been made;</u>
(3)	in the case of an <i>investment management firm</i> , <i>personal investment firm</i> , a <i>UCITS firm</i> , <i>securities and futures firm</i> or <i>BIPRU investment</i>

	<i>firm</i> , when a <i>subsidiary</i> of the <i>firm</i> is <u>during the period</u> a <i>nominee company</i> in whose name <i>custody assets</i> of the <i>firm</i> are registered <u>during the period</u> , that <i>nominee company</i> has maintained throughout the year <u>period</u> systems for the custody, identification and control of <i>custody assets</i> which:
(a)	are <u>were</u> adequate; and
(b)	include <u>included</u> reconciliations at appropriate intervals between the records maintained (whether by the <i>firm</i> or the <i>nominee company</i>) and statements or confirmations from <i>custodians</i> or from the <i>person</i> who maintains <u>maintained</u> the record of legal entitlement; and
(4)	if there has been a <i>secondary pooling event</i> during the period, the <i>firm</i> has complied with the <i>rules</i> in CASS 5.6 and CASS 7A (Client money distribution) in relation to that pooling event.

3.10.5A R In relation to a client assets report provided in accordance with SUP 3.10.4R, an auditor must ensure that it:

- (1) is submitted in the form prescribed by SUP 3 Annex 1R; and
- (2) is signed on behalf of the audit firm by the individual with primary responsibility for a firm's client assets report and in that individual's own name.

3.10.5B G SUP 3.10.4R provides that an auditor must ensure that a client assets report is prepared in accordance with the terms of, as the case may be, a reasonable assurance engagement or a limited assurance engagement. However, the FSA also expects an auditor to have regard, where relevant, to material published by the Auditing Practices Board that deals specifically with the client assets report which the auditor is required to submit to the FSA. In the FSA's view, a client assets report that is prepared in accordance with that material is likely to comply with SUP 3.10.4R and SUP 3.10.5R where that report is prepared for a firm within the scope of the material in question.

3.10.5C R (1) An auditor must ensure that the information provided to it by a firm in accordance with SUP 3.11.1G is included in the client assets report.

(2) If by the date at which the report is due for submission in accordance with SUP 3.10.7R or SUP 3.10.8AR an auditor has not received the information prescribed in SUP 3.11.1G it must submit the report without that information, together with an explanation for its absence.

Client assets report: period covered

3.10.6 R The period covered by a report under SUP 3.10.4R must end not more than

53 weeks after the period covered by the previous report on such matters, or, if none, after the *firm* is *authorised* or becomes a *firm* to which ~~SUP 3.10 applies~~ subject to SUP 3.11 and its auditor becomes subject to SUP 3.10.

Client assets report: timing of submission

- 3.10.7 R An auditor must deliver a client assets report under SUP 3.10.4R to the FSA within ~~a reasonable time from~~ four months of the end of each period covered, unless it is the auditor of a *firm* falling within category (10) of SUP 3.1.2R.
- 3.10.7A G ~~A period of four months, in ordinary circumstances, would be considered by the FSA as a reasonable time for the auditor to deliver the client assets report to the FSA. [deleted]~~
- 3.10.8 R (1) ~~If an auditor is unable to report to the FSA within a reasonable time, the auditor must notify the FSA and advise the FSA of the reasons why it has been unable to meet the requirements of SUP 3.10.7R~~ expects that it will fail to comply with SUP 3.10.7R, it must no later than the end of the four month period in question:
- (a) notify the FSA that it expects that it will be unable to deliver a client assets report by the end of that period; and
- (b) ensure that the notification in (a) is accompanied by a full account of the reasons for its expected failure to comply with SUP 3.10.7R.
- (2) If an auditor fails to comply with SUP 3.10.7R, it must promptly:
- (a) notify the FSA of that failure; and
- (b) ensure that the notification in (a) is accompanied by a full account of the reasons for its failure to comply with SUP 3.10.7R.

...

- 3.10.8D R An auditor must:
- (1) deliver to a *firm* a draft of its client assets report such that the *firm* has an adequate period of time to consider the auditor's findings and to provide the auditor with comments of the kind to which SUP 3.11.1G refers; and
- (2) unless it is the auditor of a *firm* falling within category (10) of SUP 3.1.2R, deliver to the *firm* a copy of the final report at the same time as it delivers that report to the FSA in accordance with SUP 3.10.7R.

...

Client assets report: requirements not met or inability to form opinion

- 3.10.9 R If the client assets report under *SUP* 3.10.4R states that one or more of the applicable requirements described in *SUP* 3.10.5R(1) to (4) has or have not been met, the auditor must specify in the report each of those requirements, and the respects in which it has or they have not been met.
- 3.10.9A R (1) Whether or not an auditor concludes that one or more of the requirements specified in *SUP* 3.10.5R(1) to (4) has or have been met, the auditor must ensure that the client assets report identifies each individual *rule* in respect of which a breach has been identified.
- (2) If an auditor does not identify a breach of any individual *rule*, it must include a statement to that effect in the client assets report.
- 3.10.9B R For the purpose of *SUP* 3.10.9R and *SUP* 3.10.9AR, an auditor must ensure that the information prescribed under those *rules* is submitted using, respectively, Part 1 (Auditor's Opinion) and Part 2 (Breaches Schedule) of *SUP* 3 Annex 1R.
- 3.10.9C G (1) The *FSA* expects that the list of breaches will include every breach of a *rule* in *CASS* insofar as that *rule* is within the scope of the client assets report and is identified in the course of the auditor's review of the period covered by the report, whether identified by the auditor or disclosed to it by the *firm*, or by any third party.
- (2) For the purpose of determining whether to qualify its opinion or express an adverse opinion, the *FSA* would expect an auditor to exercise its professional judgment as to the significance of a *rule* breach, as well as to its context, duration and incidence of repetition. The *FSA* would expect an auditor to consider the aggregate effect of any breaches when judging whether a *firm* had failed to comply with the requirements described in *SUP* 3.10.5R(1) to (4).
- ...
- 3.10.11 G ~~An auditor may at the *firm's* request include the matters required under this section in a separate report to that required under section *SUP* 3.9. [deleted]~~
- ...

After *SUP* 3.10 insert the following new section. The text is not underlined.

3.11 Review of auditor's client assets report

- 3.11.1 G A *firm* should ensure that:
- (1) it considers the draft client assets report provided to the *firm* by its auditor in accordance with *SUP* 3.10.8DR(1) in order to provide an explanation of:

- (a) the circumstances that gave rise to each of the breaches identified in the draft report; and
 - (b) any remedial actions that it has undertaken or plans to undertake to correct those breaches; and
 - (2) the explanation provided in accordance with (1):
 - (a) is submitted to its auditor in a timely fashion and in any event before the auditor is required to deliver a report to the *FSA* in accordance with *SUP* 3.10.7R or to the *firm* in accordance with *SUP* 3.10.8AR as the case may be; and
 - (b) is recorded in the relevant field in the draft report submitted to it by its auditor.
- 3.11.2 R A *firm* must ensure that the final client assets report delivered to it in accordance with *SUP* 3.10.8AR or *SUP* 3.10.8DR(2) is reported to that *firm's governing body*.
- 3.11.3 G The *FSA* expects a *firm* to use the client assets report as a tool to evaluate the effectiveness of the systems that it has in place for the purpose of complying with requirements to which *SUP* 3.10.5R refers. Accordingly, a *firm* should ensure that the report is integrated into its risk management framework and decision-making.
- 3.11.4 G *SUP* 3.4.2R provides that a *firm* must take reasonable steps to ensure that its auditor has the required skill, resources and experience to perform its functions. The *FSA* expects a *firm* to keep under review the adequacy of the skill, resources and experience of its auditor and should critically assess the content of the client assets report as part of that ongoing review.

...

continued

After SUP 3.11 insert the following new annex. The text is not underlined.

SUP 3 Annex 1R

Auditor's client assets report Part 1 – Auditor's Opinion

Independent auditor's report on client assets to the Financial Services Authority in respect of [*Firm name*], FSA reference number [*number*], for the period started [*dd/mm/yyyy*] and ended [*dd/mm/yyyy*]

Part 1: Auditor's Opinion on Client Assets

We report in respect of [*Firm name*] ('the firm') on the matters set out below for the period started [*dd/mm/yyyy*] and ended [*dd/mm/yyyy*] ('the period').

Our report has been prepared as required by SUP 3.10.4R and is addressed to the Financial Services Authority ('the FSA') in its capacity as regulator of financial services firms under the Financial Services and Markets Act 2000.

Basis of opinion

We have carried out such procedure as we considered necessary for the purposes of this report in accordance with [*specify Standard/Guidance used*] issued by the [*specify organisation name*].

This opinion relates only to the period and should not be seen as providing assurance as to any future position, as changes to systems or control procedures may alter the validity of our opinion.

Opinion

In our opinion:

[The firm has maintained] [Except for...the firm has maintained] [Because of...the firm did not maintain] systems adequate to enable it to comply with [the custody rules,] [the collateral rules,] [the mandate rules] [and] [the client money rules] throughout the period since [the last date at which a report was made] [the firm was authorised] [the firm became subject to SUP 3.11 and we, its auditor, became subject to SUP 3.10].*

[The firm was] [Except for...the firm was] [Because of...the firm was not] in compliance with the [the custody rules,] [the collateral rules,] [the mandate rules] [and] [the client money rules] as at the period end date.*

~/~

The scope of the firm's permissions did not allow it to hold [client money] [or] [custody assets].

The directors (or equivalent corporate officers) of the firm have stated that the firm did not hold [client money] [or] [custody assets] during the period. Based on review procedures

performed, nothing has come to our attention that causes us to believe that the firm held [client money] [or] [custody assets] during the period.

~ / ~

In our opinion, [*name of nominee companies*], subsidiaries of the firm which are nominee companies during the period in whose name custody assets are registered, those nominee companies have maintained throughout the period systems for the custody, identification and control of custody assets which:

- a) were adequate; and
- b) included reconciliations at appropriate intervals between the records maintained (whether by the firm or the nominee company) and statements or confirmations from custodians or from the person who maintained the record of legal entitlement. **

~ / ~

In relation to the secondary pooling event during the period, the firm has complied with the rules in [CASS 5.6] [and] [CASS 7A (client money distribution)] in relation to that pooling event.

~ / ~

Other matters

The report should be read in conjunction with the Breaches Schedule that we have prepared and which is appended to it. [Our opinion expressed above does not extend to the Breaches Schedule.]

[*Signature of the partner/individual with primary responsibility within the audit firm*]
[*Typed name of signing individual*]

for and on behalf of [*Name of the audit firm*]

[*registered office*]
[*Date report*]

Instructions for Part 1:

* If the auditor expresses an adverse opinion (i.e. states the firm ‘did not maintain...’ or ‘was not in compliance...’) he must set out the reasons why. This can be done by reference to items in columns A to D in Part 2 of the auditor’s report on client assets.

If the auditor expresses a qualified opinion (i.e. states ‘that except for, the firm did maintain’ or ‘that except for, the firm was in compliance’) he must do so by reference to items in columns A to D in Part 2 of the auditor’s report on client assets.

** In accordance with SUP 3.10.5R(3), the opinion relating to the nominee company is only required to be included in the case of a nominee company in whose name custody assets are registered where that company is a subsidiary of an investment management firm, personal investment firm, a UCITS firm, securities and futures firm or BIRPU investment firm.

Auditor's client assets report Part 2 – Breaches Schedule

Part 2: Identified CASS Breaches that have occurred during the period

[*Firm name*], FSA reference number [*number*], for the period started [*dd/mm/yyyy*] and ended [*dd/mm/yyyy*]

In accordance with SUP 3.10.9AR, Columns A to D are to be completed by and are the responsibility of the auditor. In accordance with SUP 3.11.1G, Column E should be completed by the firm. The auditor has no responsibility for the content of Column E.

Column A	Column B	Column C	Column D	Column E
Item No.	Rule Reference(s)	Identifying party	Breach Identified	Firm's Comment
1				
...				

Instructions for Part 2:

In Columns A to D of the above schedule the auditor is to set out all the breaches of CASS by the firm occurring during the period subject to the auditor's report. These must include the breaches the auditor has identified through its work (such as in the sample testing of reconciliations) and breaches identified by the firm or any other party (such as those included in the firm's breaches register). In relation to any breach identified, the auditor must provide in Column D any information that it has as respects the severity and duration of the breach identified and, where relevant, the frequency with which that breach has occurred.

The auditor must provide a 'nil' return for this part of the report where no CASS rule breach has been identified.

In Column E the firm should set out any remedial actions taken (if any) associated with the breaches cited, together with an explanation of the circumstances that gave rise to the breach in question.

TP 1 Transitional Provisions

...

After TP 1.6 insert the following new transitional provisions. The text is not underlined.

TP 1.7 Client assets report

(1)	(2)	(3)	(4)	(5)	(6)
	Material to which the transitional provision applies		Transitional Provision	Transitional provision: dates in force	Handbook provision: coming into force
1	The <i>rules and guidance</i> in SUP 3.10	R	In relation to an auditor of a <i>firm</i> whose client assets report period ends on or before 29 September 2011, that auditor may comply with SUP 3.10 as it was in force on 31 May 2011.	From 1 June 2011	1 June 2011
2	The <i>rules and guidance</i> in SUP 3.11	R	In relation to a <i>firm</i> whose client assets report period ends on or before 29 September 2011, the <i>rules and guidance</i> to which column (2) refers do not apply.	From 1 June 2011	1 June 2011

...

Sch 2 Notification requirements

...

Sch 2.2G

Handbook reference	Matter to be notified	Contents of notification	Trigger event	Time allowed
...				
SUP 3.10.4R	Auditor: client assets <u>client assets</u>	Either:	Report period must end no	A reasonable time <u>Other</u>

	<p><u>report.</u></p>	<p>(1) Whether <i>firm</i> has: maintained systems to comply with CASS (<i>client assets</i>), is in compliance with the <i>client asset rules</i> at the report date, and <i>nominee company</i> records are adequate a report which states the matters set out in SUP 3.10.5R and which specifies the matters to which SUP 3.10.9R and SUP 3.10.9AR refer; or</p> <p>(2) if the <i>firm</i> claims not to hold <i>client money</i> or <i>custody assets</i>, a report which states whether anything has come to the auditor's attention that causes him to believe that they were held during the period covered by the report.</p>	<p>more than 53 weeks after previous report The obligation in SUP 3.10.7R to submit a report within a specified period of time.</p>	<p>than in the case of the auditor of a <i>firm</i> falling within category (10) of SUP 3.1.2R, four months from the end of the period covered by the report.</p>
<p>SUP 3.10.8R(1)</p>	<p>Failure <u>Expectation</u> by auditor to report under SUP 3.10.4R that it will fail to comply with SUP 3.10.7R.</p>	<p>Auditor to report the failure and the reasons why it has been unable to meet the requirements of SUP 3.10.7R fact of its expected failure to comply and a full account of the reasons for its expected failure.</p>	<p>Failure <u>The expected failure</u> by the auditor to comply with SUP 3.10.7R deliver a report under SUP 3.10.4R to the FSA so as to be received within four months of the end of each the period covered by the report.</p>	<p>Not specified <u>No later than the end of the four month period in question.</u></p>

<u>SUP</u> <u>3.10.8R(2)</u>	<u>Failure by auditor</u> <u>to comply with</u> <u>SUP 3.10.7R.</u>	<u>Auditor to report the</u> <u>fact of its failure and</u> <u>a full account of the</u> <u>reasons for its failure.</u>	<u>Failure to</u> <u>comply with</u> <u>SUP 3.10.7R.</u>	<u>Promptly.</u>
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