Policy Statement

PS12/23

Financial Services Authority

Client assets regime: changes following EMIR

December 2012

Financial Services Authority

Contents

This Policy Statement summarises feedback received in relation to **Part I of Consultation Paper 12/22** (CP12/22) and publishes final rules making changes pursuant to the European Market Infrastructure Regulation (EMIR). Feedback on Parts II and III of CP12/22 will be published at a later date.

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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.

Abbreviations used in this paper

CASS	Client assets sourcebook
CCP	Central counterparty authorised or recognised under EMIR
CP	Consultation Paper
EMIR	Regulation (EU) no 648/2012 on OTC derivatives, central counterparties and trade repositories, commonly referred to as the European Market Infrastructure Regulation
ESMA	European Securities and Markets Authority
MiFID	Directive no. 2004/39/EC on markets in financial instruments, commonly referred to as the Markets in Financial Instruments Directive
PPE	Primary pooling event
PS	Policy Statement
RTS	Regulatory Technical Standards
TTCA	Title transfer collateral arrangements

1 Overview

Introduction

1.1 We have to change our rules on client assets to accommodate the European Market Infrastructure Regulation (EMIR). We consulted on this earlier this year and are now setting out the final rules.

1.2 So this Policy Statement (PS) summarises the feedback we received to our *Consultation Paper 12/22 Part I: Changes to CASS required by EMIR* (CP12/22), provides our response to this feedback and publishes final rules making changes to the client assets sourcebook (CASS).

1.3 In this paper, we only address EMIR to the extent that it affects CASS and is separate from other changes being made to the FSA Handbook relating to EMIR. This PS does not address wider concerns on the implementation of EMIR more generally.

1.4 This PS does not summarise feedback to, or publish final rules for Parts II and III of CP12/22. These parts of the consultation closed on 30 November 2012 and we are still considering the feedback we have received.

Background

1.5 As explained in CP12/22, EMIR is a European regulation and is directly applicable to central counterparties (CCPs) and their clearing members in the UK. If the European Commission meets its target date of 31 December 2012 to adopt various Regulatory Technical Standards (RTS) put forward by the European Securities and Markets Authority (ESMA) in September 2012, various obligations under EMIR will enter into force early in 2013. We believe the amendments to the CASS rules should enter into force in parallel with the expected implementation timetable of EMIR. So to ensure that market participants can

be certain of the impact of EMIR on the CASS regime during the lead up to full implementation of EMIR, the final rules resulting from CP12/22 Part 1 come into force on 1 January 2013.

Changes to CASS required by EMIR

1.6 Under EMIR, when a CCP determines that a clearing member firm is in default, the client transactions (also referred to as 'positions') the clearing members holds in client accounts at the CCP and the margin supporting those transactions in the same accounts may be transferred to another client account held by a back-up clearing member. We refer to this process of transferring positions and margin to another clearing member as 'porting' or 'port', 'ported', etc.

1.7 In the event of a clearing member default, EMIR also requires the CCP to return any balance of clients' collateral from the failed clearing member's client accounts at the CCP directly to the clients or back to the failed clearing member for the account of its clients.

1.8 Clearing members of CCPs will often be 'firms' as defined in the FSA Handbook, who hold client money for the purposes of the CASS rules. Margin transferred by a firm to a client account at a CCP may be client money from the perspective of the clearing member.

1.9 Under the current CASS rules, the failure of a firm triggers a primary pooling event (PPE). A firm default called by a CCP may be due to the failure of the firm (although this will not always be the case). At the time of a PPE, all the firm's client money is pooled for distribution, including any amount payable by a CCP for a client transaction account. In our consultation (Part I of CP12/22) we proposed amending CASS to comply with EMIR, so that client money that is held by a clearing member firm in a client transaction account at a CCP is excluded from the pooling and distribution triggered by a PPE.

Structure of this paper

1.10 In Chapter 2 we explain the issues raised by the consultation respondents, including: the scope of the CCPs referred to in CASS 7 and CASS 7A; the market practice of firms pre-funding margin calls relating to cleared client transactions and the interaction of this with the EMIR requirements; the use of title transfer collateral arrangements in the context of cleared client transactions; and the timing of the entry into force of the final rules published in this PS with the expected timetable for implementation of EMIR at the European level.

1.11 In Chapter 3 we then summarise responses to the questions we asked in CP12/22 Part I and provide our responses.

1.12 The final rules are included as an Annex to this paper and come into force on 1 January 2013.

Cost benefit analysis

1.13 The final rules as set out in the Annex to this PS do not depart significantly from those set out in CP12/22 Part I. Changes to the draft rules published in CP12/22 Part I respond to feedback received in the consultation and ensure that CASS is not in contradiction with EMIR. We do not expect these minor changes to impose incremental cost on firms so there is no need to revisit the cost benefit analysis (CBA) set out in CP12/22 for Part I. A couple of respondents did note that there are likely to be incremental compliance costs; however, they also said these stemmed from EMIR, rather than our proposed changes to CASS rules.

Who should read this Policy Statement?

1.14 This PS will be of particular interest to:

- firms, in particular, clearing members of CCPs, and their clients;
- trade associations of such firms and CCPs; and
- CCPs, in order for them to understand the rules that apply to some of their clearing members.

Next steps

1.15 The instrument published with this PS comes into force on 1 January 2013. We do not anticipate any material operational changes for firms.

1.16 The consultation and discussion in Parts II and III of CP12/22 closed on 30 November 2012. We are considering the feedback received and intend to publish our response in the first half of 2013.

EMIR Regulatory Technical Standards

1.17 We are currently considering the implications of the RTS relating to EMIR that have been passed from ESMA to the European Commission. Once the RTS are final, we will consult in the first quarter of 2013 on any resulting necessary changes to the CASS rules.

Annex 1 of CASS 7

1.18 We are also considering the impact of EMIR on the application of the margin transaction requirement in paragraph 14 of Annex 1 of CASS 7. If necessary, we may share the outcome of these considerations in the first quarter of 2013.

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Issues raised in response to CP12/22 Part I

2.1 We received 18 responses to CP12/22 Part I from a range of trade associations, regulated firms and professional firms. Respondents raised several issues that were not directly addressed by the questions we asked in CP12/22 Part I. We believe this stems in part from respondents using the opportunity to request clarifications of some of the EMIR requirements.

2.2 Before responding to the feedback we received to questions 1 and 2 of CP12/22 Part I, we are first using this chapter to set out the broad issues that were raised by respondents and to provide a response. In chapter 3, we then address feedback to the questions we asked in CP12/22 Part I.

2.3 Please note that in this PS we will address respondents' concerns about EMIR in the context of, and to the extent that they relate to, CASS. This PS does not address wider concerns on the implementation of EMIR more generally.

Status of CCPs under EMIR

2.4 We received comments on the types of CCPs that would be covered by the amended CASS rules. In particular, respondents were anxious that our rules should cover a situation where a clearing member is doing cleared business for its clients through a third-country CCP recognised under Article 25 of EMIR.

2.5 In addition, a few respondents asked us to take into account the interim period during which CCPs will be allowed to operate before their applications to become authorised or recognised under EMIR have been completed. Other respondents asked us to make clear whether our rules would apply to CCPs neither authorised nor recognised under EMIR such as those referred to in EMIR Recital 59 with which firms may deal indirectly through a third country clearing member.

Our response

We agree with feedback that our rules should take into account both EU CCPs authorised under EMIR and third-country CCPs recognised under EMIR. We have amended our rules so they will extend to situations where a clearing member is a member of a CCP recognised under EMIR.

During the interim period between our amended rules coming into force and the subsequent authorisation or recognition of a CCP under EMIR, if a clearing member firm defaults, that CCP will not be permitted by the CASS rules to port client money margin held in such a firm's client transaction accounts at the CCP. In CP12/22 Part I we conducted a short consultation in order to accommodate EMIR by 1 January 2013. With this in mind we did not consider it appropriate to permit porting before CCPs and their clearing member firms are required by EMIR to offer this.

We understand that a third-country CCP wishing to provide clearing services to clearing members or trading venues established in an EU member state will need to become recognised under EMIR. However, a third-country CCP providing services to clients established in the EU through a clearing member established in a third-country will not have to be recognised under EMIR. The CASS rules have not been amended to capture such 'unrecognised' third-country CCPs because the CASS rules would not be applicable to their clearing members based outside the EU (as the CASS rules are, broadly speaking, only applicable to UK firms and their branches in the EEA).

Possible account types

2.6 Several respondents asked us to clarify the types of client accounts that can be offered by CCPs and firms under EMIR. A number of respondents were concerned that the CASS rules should not restrict client account type offerings. They felt that they should be able to offer accounts that are in compliance with EMIR, but not necessarily one of the two options expressly contemplated by EMIR (individual and omnibus client accounts). Some respondents asked us to expressly allow for 'gross omnibus accounts' in the CASS rules.

Our response

EMIR requires in Article 39(5) that CCPs offer 'at least, the choice between omnibus client segregation and individual client segregation'.[1] The European Commission has further stated that this means CCPs must offer these two types of segregation as a minimum.[2]

We note the requests for our rules to expressly allow for 'gross omnibus accounts'. We do not intend to unduly restrict the types of accounts that clearing members may wish to offer to their clients, provided that they comply with EMIR, and we do not consider that our rules are restrictive in this way. We note that Article 39 of EMIR does not indicate whether clients pertaining to an omnibus client account should be margined on a net or gross basis (i.e. net across all clients or gross per client after netting all positions of that client). We have amended our rules to treat a remittance to a firm for an omnibus account where it is, broadly, functionally equivalent to a collection of individual client accounts, in the same way as an individual client account. Please also see Chapter 3.

At this stage we do not think that it would be helpful for our rules to define account types other than those specified in EMIR. This is due to several reasons, including: the difficulty in pinpointing the exact characteristics of other possible account types and differentiating these from the account types specified in EMIR; and the fact that we consulted in CP12/22 Part I on *only* those changes necessary to accommodate EMIR by 1 January 2013.

Title transfer collateral arrangements (TTCA)

2.7 A large number of respondents raised questions related to the use by clearing members and their clients of title transfer collateral arrangements (TTCA) and how EMIR would impact these arrangements.[3] These questions related to EMIR itself as well as on our proposed rules.

2.8 Regarding EMIR, some respondents asked why a firm that had received margin monies on a TTCA basis was obliged to place such margin monies in a separate account at a CCP from its own house account. Another respondent challenged our assertions in paragraph 2.24 of CP12/22 that a firm must have different types of accounts at a CCP to prevent it from mixing its own house monies with money received from its clients under the client money rules and/or with money received from clients on a TTCA basis. They said this went beyond the requirements of EMIR.

1 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF

2 European Commission *EMIR: Frequently Asked Questions*, question 12, accessible at http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/doc_121114_emirfaqs_en.pdf.

3 CASS 7.2 addresses the use of TTCAs. CASS 7.2.3R covers situations where a client transfers full ownership of money to a firm for the purpose of securing or otherwise covering present or future, actual or contingent, or prospective obligations. Monies transferred by clients to firms in this way are no longer client money. This reflects the wording from MiFID.

2.9 There was general concern about the effect of Article 48 of EMIR requiring the positions and assets on an individual client account to be ported or any account balance in respect of clients' collateral to be remitted directly to the client on the default of a clearing member where the clearing member and the client had a TTCA relationship, since this was seen as inconsistent with TTCAs and unfairly benefitting the client.

2.10 Some responses asked for clarification that the proposed Handbook text in CP12/22 Part I was only applicable to client money received by a firm from its clients under CASS, and that it did not apply to money received by a firm from its clients under a TTCA.

2.11 Some respondents asked why any client money would be involved, saying that CCPs do not hold client money.

Our response

In CP12/22 Part I we included a short clarification about the use of TTCA.[4]

It is important to be clear what we mean by 'title transfer collateral arrangement' or 'title transfer financial collateral arrangement' between a clearing member firm and its client. The CASS rules have adopted the wording from MiFID: 'where a client transfers full ownership of money to a firm for the purpose of securing or otherwise covering present or future, actual or contingent, or prospective obligations' (CASS 7.2.3R). The intention of the client and the firm is that the client should cease to have any interest in that money; the client willingly becomes a creditor of the firm for repayment of any balance; and the money cannot be said to be held on behalf of that client.

We note that a few respondents felt it unlikely that many clearing arrangements involved client money, as they felt 'the use of TTCA' was prevalent. However, there may be some confusion resulting from a failure to distinguish between a TTCA between a client and a clearing member, and a TTCA between a clearing member and a CCP. The services provided by the clearing member to the client come under the scope of MiFID and it should not, and indeed cannot be assumed that this will be a TTCA relationship. CCPs and clearing members should contemplate this possibility and its policy rationale. Since so many people asked us about this, here is our position.

4 CP12/22, *Client assets regime: EMIR, multiple pools and the wider review*, paragraphs 2.21 – 25: www.fsa.gov.uk/library/policy/cp/2012/12-22.shtml.

Where a firm provides client money protection to its clients in line with CASS (and MiFID)

Broadly speaking, where an investment firm receives money from or holds money for, or on behalf of a client in the course of or in connection with MiFID business and/or investment business, the client money rules set out in Chapter 7 of CASS (CASS 7) will apply to that investment firm and the firm will receive or hold that money as trustee. For example, where a firm enters into certain types of derivatives transactions for a client and it holds margin money for or on behalf of its client in connection with those transactions, the firm will need to treat that money as client money under CASS 7. If a firm holds margin money that is client money under CASS 7 in connection with a derivatives transaction and it wishes to, or is obliged to clear that transaction through a CCP, the firm may transfer that client money to a CCP to be held by that CCP (CASS 7.5.2R). However, before transferring this client money to a CCP, the firm must open a client transaction account at the CCP, notify the CCP that the firm is obliged to keep its clients' money separate from its own money and it must require the CCP to provide a written acknowledgement that the client transaction account cannot be combined with or set off against any other account (CASS 7.8.2R).

Where a clearing member firm is acting in line with its obligations under CASS and transfers client money to a client transaction account at a CCP in connection with transactions that the firm has entered into on behalf of its underlying client, the firm must treat the receivable from the client transaction account as client money[5] and the CCP has notice of the firm's duty to its clients under the CASS rules. We consider that a trustee who has the authority of its clients and complies with the CASS rules can deliver full ownership of money to a CCP under a TTCA. The fact that the rules of a CCP may require delivery of margin under a TTCA does not prevent the firm having to account for that receivable as client money, nor would it, by itself, justify the CCP acting in a way which is inconsistent with the firm's obligations to its clients under the client money rules.

If the clearing member becomes insolvent, a PPE under the client money distribution rules (CASS 7A) will be triggered. Without the amendments that we have made in this PS to the CASS 7A rules, on the occurrence of a PPE all client money held in the firm's client money bank accounts and client transaction accounts (including those at the CCP) would be treated as forming a single client money pool for distribution to the firm's clients who receive client money protection pursuant to CASS 7. It is important to keep in mind: (i) clients of the firm (for whom client money is held) have only an entitlement to share in the pool according to their respective interests; and (ii) the legal nature of the pool is such that, until ascertained, it is impossible to allocate a specific amount of that pool to any specific client.

5 This is akin to client money being placed by an investment firm with a bank: the bank takes full title to the money, but the receivable is always client money and the investment firm remains subject to CASS.

So there is a conflict between the formation of a single pool and the inability to allocate a specific amount of that pool to specific clients, and a default procedure of a CCP that would seek to allocate a specific amount of margin to support the transfer of a position held for a client in a client transaction account to another clearing member. This is despite that from the CCP's perspective it has received full ownership of the monies and its rules contemplate a broad range of procedures, including porting.

If an investment firm has an individual client account or omnibus client account (as defined in the final rules in the Annex to this PS) at an EMIR authorised or recognised CCP and is insolvent, any client money held in that client transaction account will not form part of the client money pool if it is ported or returned directly to the client. This will be the case from 1 January 2013 when the final rules set out in the Annex to this PS come into force.

Where a firm has in place TTCAs with its clients

In some instances, a firm may enter into a TTCA with a client. Money transferred by a client to an investment firm under a TTCA in connection with, for example, derivative transactions that the firm is entering into on the client's behalf is not the client's money, so will not be subject to CASS 7.

Under EMIR, a firm entering into a transaction on behalf of its client must offer that client the choice between individual and omnibus client segregation at a CCP. This broadly means that at a minimum, the client's assets and positions must be recorded in separate accounts at the CCP from those of the firm. Also, there can be no netting of positions in client accounts against positions in a firm's account and the assets covering the positions recorded in a client account should not be exposed to losses connected to positions recorded in a firm's account. In keeping with these requirements, even if the firm conducts its business with a client on a TTCA basis, in the context of cleared transactions, it must still offer this choice between individual and omnibus client segregation at a CCP in line with EMIR.

Subject to limited exceptions, CASS does not allow client money and non-client money to be co-mingled. This means that where a firm that contracts with certain clients on a TTCA basis but provides other clients with client money protection under the client money rules, that firm will need to maintain one or more client transaction accounts (as defined for the purposes of CASS) for CASS 7 clients and one or more other accounts for its clients who provide money to the firm under a TTCA. This ensures that for these different types of client, client money (from the perspective of the firm) is never co-mingled with other monies.

The proposals and final rules set out in this PS apply to client transaction accounts held at a CCP, but do not apply to other accounts maintained by a firm at a CCP, including an account that contains margin monies collected by a firm from its

clients on a TTCA basis. We must not infer from the terminology of EMIR that an individual client account and an omnibus client account necessarily hold client money under CASS, despite the protections of Articles 39 and 48 of EMIR applying to all accounts opened by a firm on behalf of its clients at a CCP.

We note the concern from the industry around the interpretation of the meaning of 'for the account of its clients' in Article 48(7) of EMIR. We reiterate that this paper only addresses EMIR to the extent that it affects CASS. To the extent it affects CASS, we set out in paragraphs 3.13-3.20 our view on the treatment of client money balances returned by a CCP to a defaulting firm in respect of individual client accounts and omnibus client accounts in the context of CASS.

Pre-funding of margin calls

2.12 There were a large number of comments on the market practice of 'pre-funding' margin calls. These drew attention to the fact that when CCPs call variation margin from clearing members for a client transaction account, the clearing member is obliged to respond by posting that margin within a short period. In many cases, although the clearing member may immediately pass on this margin call to its client, the client will not be able to transfer the sum quickly enough for the clearing member to meet the CCP's margin call. Consequently clearing members 'pre-fund' the margin calls on CCP client transaction accounts by extending credit to the clients in question to ensure that margin calls are met within the requisite period.

2.13 Respondents queried how such pre-funding arrangements should be taken into account in the event of a firm's failure in which EMIR contemplates the porting of margin in client accounts at the CCP and/or the return by the CCP directly to the client the balance following the default management process.

Our response

We understand that clearing member firms do on occasion pre-fund margin calls for client transaction accounts at CCPs in this way, incurring credit risk on these clients.

When a clearing member pays money into a client transaction account at a CCP, the firm should account for this as part of its client money requirement under CASS.

Firms assess the risks involved in pre-funding specific clients. This assessment must take into account that on the firm's own default, any such pre-funded margin in a client transaction account at a CCP might be ported to a back-up

clearing member or be remitted by the CCP directly to a client in line with the relevant EMIR provisions before the client has paid an equivalent amount to the firm.

If a client ends up in a position of owing money to the failed or defaulted clearing member, our rules do not prevent an insolvency practitioner from pursuing any claim against that client.

Pre-funding currently takes place and is not something that EMIR will introduce. We will consider pre-funding and issues that touch on this as part of the ongoing wider CASS review.

In Chapter 3 below, from paragraph 3.22 onwards (Discharging client money responsibilities), we address the fact that calculating a client's entitlement to the client money pool on a PPE will need to be adjusted to take into account balances ported to a back-up clearing member in favour of that client, and/or balances remitted by the CCP directly to the client and/or balances returned by the CCP to the firm for the account of that client.

Timing of CP12/22 and EMIR implementation timetable

2.14 A few respondents felt that the date we proposed in CP12/22 to publish this PS and for the entry into force of the rules was too soon, while a few agreed with the timetable proposed in the CP. One respondent asked us to make it clear when the EMIR porting and segregation requirements come into force.

2.15 Some respondents including a trade association, felt that there was uncertainty stemming from the longer consultation period for Parts II and III of CP12/22.

Our response

These amendments to CASS are required to accommodate EMIR. EMIR is somewhat unusual in that it came into force on 16 August 2012, but it is accepted that many of the obligations do not enter into force until various RTS are adopted. Depending on the European Parliament and Council, most RTS could come into effect in February or March 2013. Even after those RTS are adopted, some obligations depend on certain steps being taken, such as CCPs obtaining authorisation or recognition.

We expect CCPs to apply for authorisation under EMIR at the earliest opportunity in 2013 and the provisions of EMIR relevant to the segregation and portability of client positions and margin will apply as soon as the first CCP is authorised, at which point the CASS rules will need to accommodate EMIR.

We believe that it is appropriate that the amendments to the CASS rules enter into force in parallel with the expected implementation timetable of EMIR. To ensure that market participants can be certain of the impact on the CASS regime during the lead up to full implementation of EMIR, we still believe the amended rules as set out in the Annex to this PS should come into force on 1 January 2013.

This will ensure that CCPs and clearing members can understand the obligations of CASS as they are developing their arrangements to comply with EMIR.

Indirect clearing and the EMIR Regulatory Technical Standards (RTS)

2.16 ESMA published detailed RTS supporting EMIR on 27 September 2012.

2.17 These RTS include provisions relating to indirect client clearing, that is, where a clearing member's client offers clearing services to its own clients. We continue to consider the impact of these draft RTS on the CASS rules.

2.18 We will consult on the RTS and any impact on the CASS rules once the RTS are final. This is likely to leave a relatively short period for consultation before the RTS come into force.

CASS 6

2.19 A few respondents asked about the potential need to make changes to CASS 6 (custody rules) as a result of EMIR.

Our response

In CP12/22 and this PS we have intended to address only those matters necessary to ensure that CASS does not conflict with the provisions of EMIR. The main conflict between CASS and EMIR stems from the requirement in CASS 7A (client money distribution) to notionally pool all client money held by a firm on its failure and return it to the relevant clients. There is no equivalent requirement in CASS 6 (custody rules) for pooling where assets are concerned, and so this conflict is avoided.

As the implementation of EMIR proceeds, we will continue to assess whether any other changes to our rules are necessary, including as part of the matters raised in CP12/22 Parts II and III.

FSA engagement with HM Treasury

2.20 Several respondents urged us to engage with HM Treasury (the Treasury) regarding the proposed rule changes, EMIR and in relation to work the Treasury is undertaking to amend Part VII of the Companies Act 1989 to accommodate the requirements of EMIR.

Our response

We have engaged with the Treasury on our proposals, the CASS rules amendments and its work to amend Part VII of the Companies Act 1989.

We will continue to work closely with the Treasury on these matters and in the context of its review of the Investment Bank Special Administration Regime (SAR).

3

Responses to questions 1 and 2 of CP12/22 Part I

3.1 In this chapter, we summarise the feedback we received to questions 1 and 2 of CP12/22 and our response to this feedback. We also explain any changes we are making to the proposed amendments to CASS 7 and CASS 7A that were set out in CP12/22 Part I to accommodate the measures introduced by EMIR. Chapter 2 provides context and rationale on this.

Changes to the Client Money Rules (CASS 7) and Client Money Distribution Rules (CASS 7A)

3.2 In CP12/22 Part I we proposed changes to CASS 7 and CASS 7A to accommodate the measures introduced by EMIR.

3.3 By way of reminder, EMIR introduces certain segregation and portability requirements. EMIR requires CCPs to keep separate records and accounts so its clearing members can distinguish assets and positions:

- held for the clearing member from those of its clients (this is called 'omnibus client segregation'); and
- held for one client from those held for other clients (this is called 'individual client segregation').

3.4 Clearing members are required to then offer 'at least' these types of segregation to their own clients.

3.5 In addition under Article 48 of EMIR, if the clearing member defaults, a CCP must attempt to 'port' any client positions and associated margin held by a CCP to another solvent clearing member (a back-up clearing member). Once the default management process finishes, the CCP must return any balance owing on a client transaction account in respect of clients' collateral directly to the clients or to the clearing member for the account of its clients.

3.6 In CP12/22 Part I in order to allow the porting of client accounts by a CCP, we proposed that in the event of a firm insolvency client money held in a client transaction account at a CCP would not form part of the notional client money pool.

3.7 In addition, we proposed inserting a new rule into CASS 7A to address how firms should treat client money returned by a CCP to the firm for an individual client account and an omnibus client account. Broadly, we proposed that for an individual client account, balances returned to the firm should be held separately by the firm and distributed directly to the client. For omnibus client accounts, we proposed that balances returned to the firm should be contributed to the client money pool.

3.8 In CP12/22 Part I we asked:

> *Q1: Do you agree with the proposed changes to the distribution rules to permit porting? Do you agree with the treatment of balances returned to the clearing member for the account of its clients? If not, please explain why.*

Changes to permit porting

3.9 Most respondents supported the aims and objectives behind the changes proposed to CASS 7A to permit porting, as well as the rule changes themselves.

3.10 However, a number of respondents who support the proposals also expressed certain reservations about them, for example, requesting clarification of how the proposals would fit in with the practice of clearing members pre-funding margin calls on client transaction accounts and firms' use of TTCA (see Chapter 2). Some respondents also noted that they felt that porting was unlikely, especially in the case of omnibus client accounts and asked us to clarify how porting under EMIR would take place, especially for omnibus clients.

3.11 One respondent felt that porting or remitting balances to clients could be difficult for CCPs because they did not always know the underlying clients of the clearing member.

3.12 A few respondents noted that porting may result in client money being removed from the CASS regime, for example, to a non-UK clearing member.

Our response

In Chapter 2 we addressed the practice of pre-funding and the use of TTCA. EMIR is a European regulation which is directly applicable to firms and its requirements cannot be waived. Clearing members and their clients alike must take into account the risks of their commercial agreements.

We note feedback that porting may be unlikely, especially in the case of omnibus client accounts. We do not attempt to address this issue in the scope of this PS but in CP12/22 Parts II and III we do consider measures to improve the likelihood of porting and improve the client money distribution regime.

We note the response that porting or remitting balances to clients could be difficult for CCPs because the underlying clients are unknown to them. The CASS rules do not apply directly to CCPs and this is not something that CASS can address.

As noted in paragraphs 2.6 and following, at this stage we do not think that it would be helpful for our rules to define any account types other than those specified in EMIR. This is partly due to the difficulty in pinpointing the exact characteristics of other possible account types and differentiating these from the account types specified in EMIR. We will continue to assess the need to expressly recognise further possible account types in our rules as these develop.

We note that Article 39 of EMIR does not indicate whether an omnibus client account should be margined on a net or gross basis (i.e. net across all clients or gross per client after netting all positions of that client). We have amended our rules to treat a remittance to a firm for omnibus account where it is, broadly, functionally equivalent to a collection of individual client accounts, in the same way as an individual client account. Please see our response following paragraph 3.20 below for further explanation.

Regarding comments about client money being ported out of the client money regime, under EMIR clients must provide consent to back-up clearing members for porting to work and so they will be aware of the relevant arrangements.

Treatment of balances remitted to defaulting clearing member

3.13 Respondents generally agreed that client money balances returned to a defaulting firm by a CCP in respect of individually segregated client accounts should be remitted directly to clients. However, some expressed concern that this might result in an unfair windfall to the client where the firm had pre-funded the margin calls in respect of that individual client account.

3.14 A few respondents queried whether the CASS rules could legally treat balances returned by a CCP to a firm in respect of an individual client account differently from balances returned in respect of an omnibus client account.

3.15 As we noted in Chapter 2, firms and trade associations wanted to ensure our rules should remain flexible enough to allow for different account types in addition to the individual client accounts and omnibus client accounts expressly provided for in EMIR. Some respondents asked that our rules expressly provide for 'omnibus gross client accounts'. Consequently, some respondents disagreed with our proposals on the treatment of balances remitted to the defaulting clearing member for the account of its clients, as the provisions in our rules only address how balances returned in respect of individual client accounts and

omnibus client accounts should be treated. One respondent felt that balances returned by a CCP to a firm for 'gross omnibus client accounts' should be treated in a similar way to individual client accounts such that all money returned by the CCP to the firm should be returned to clients rather than being contributed to the client money pool, as proposed in relation to omnibus client accounts in our draft rules.

3.16 Respondents asked for clarification of the phrase 'for the account of its clients' in Article 48(7) of EMIR. In particular, they asked how this was to be applied where the firm and the client had a TTCA in place and for clarification as to whether such TTCA monies should form part of the insolvent estate of the firm.

3.17 One respondent asked us to clarify whether balances returned to the defaulting clearing member were for the account of only those clients to whom the account in question relates, or for the account of the firm's clients generally.

3.18 One respondent asked us to consider amending the CASS rules to reflect a situation in which client account balances are returned by a CCP to a clearing member that has defaulted under the CCP's rules, but where the clearing member is not insolvent, and there has been no PPE under CASS 7A.

3.19 A small number of respondents suggested that clearing members might need to implement operational changes as a result of the requirement to hold certain balances remitted by a CCP to the firm for the account of its clients in line with EMIR.

3.20 One respondent asked us to make it clear whether a client must make a claim against the notional client money pool before making a claim as a general creditor against the insolvent firm's own account under CASS 7A.2.6 G.

Our response

Please see our discussion in Chapter 2 in relation to pre-funding and the use of TTCA.

Although there was some agreement with the proposed rule amendments in this area, there were also concerns.

In CP12/22 Part I we explained that we proposed treating the balances returned by a CCP to the firm in respect of individually segregated accounts and omnibus segregated accounts differently. Article 48(7) of EMIR dictates how CCPs must treat balances on individual and omnibus client accounts and Article 39(9) of EMIR imposes requirements on CCPs in respect of 'distinguishing in accounts' at the CCP. However, Article 48(7) and Article 39(9) of EMIR do not impose requirements on the clearing members themselves. EMIR does not specify the way that a clearing member firm should treat balances returned by CCPs 'for the account of its clients'.

It is also clear under EMIR that the intention is that clients electing individual client account segregation are afforded a high degree of protection relative to omnibus client accounts against the default of the clearing member.

For individual client accounts, under Article 39(6) of EMIR any margin called from the client by the clearing member in excess of the CCP's requirement must be paid into the client's individually segregated account at the CCP.

The situation can be different for omnibus client accounts. Where a clearing member client selects omnibus segregation at the CCP, and this account is margined on a net basis[6], the clearing member may call margin on a gross basis[7], but then pay an amount of margin net across all the clients in that account to the CCP. This means that there will be a proportion of margin held at the clearing member level.

With these points in mind, in our view, where a CCP returns any client money balance to a firm in relation to an individual client account, due to the high degree of protection EMIR affords such clients and the fact that the firm will not be holding any part of the margin relating to the positions in that account, the firm should return this balance to the client and it should not form part of the client money pool.

We accept the feedback that omnibus client accounts may be margined in a way similar to individual client accounts and that in fact some segregation models might mean that there is no netting across clients at the CCP level.

We have therefore amended our proposed rules in relation to balances returned by a CCP in respect of omnibus client accounts.

We maintain the position that where omnibus client transaction accounts have been margined on a net basis across clients at the CCP, balances returned by a CCP to a firm in respect of such omnibus client accounts should be contributed to the client money pool. If this were not the case and the balance returned by the CCP to the firm were held separately from the client money pool, the situation would arise in which the margin returned by the CCP to the firm would be treated differently by the firm from any margin that had been held by the firm as at PPE (as this margin will have been contributed to the client money pool). From a policy perspective this is unacceptable, as this effectively means that some of a client's margin relating to its positions will be held in the client money pool and some outside of it.

To determine the correct amount of margin to be returned to each client pertaining to such an omnibus account, the sum at the CCP (the net margin), must be joined to the proportion at the clearing member level (gross less net margin). An insolvency practitioner should not be expected to determine the

6 Net across all clients' positions in that account.
7 Gross per client after netting all positions of that client.

proportion to be returned to each client out of balances returned by the CCP in respect of an omnibus client account and carry out a separate calculation to determine the amount that each client is owed from the client money pool in respect of transactions held in the omnibus client account.

However, we have amended our rules to take into account situations in which omnibus client accounts might have different characteristics that mean that the policy issues described above are avoided.

If all the client money that clients provide to a firm is transferred by the firm to the CCP as margin in relation to positions held for those clients in an omnibus client account at the CCP, then if the firm defaults and an amount of any balance remitted by the CCP for that account is readily attributable to each client, the situation is similar to a payment for an individual client account. So we have amended our rules to allow the firm to hold remittances for such accounts for the relevant clients without being contributed to the client money pool.

Given that our policy concerns outlined above will not apply, it seems reasonable that balances returned by CCPs to a firm for the account of its clients should be returned by the firm directly to such clients and need not be contributed to the client money pool on a PPE.

If a clearing member has defaulted under a CCP's rules, but there is no PPE triggering the creation of a client money pool, a CCP may return balances from any client accounts that the clearing member holds at the CCP. We have not included any new rules to cover this situation as the firm would be expected to treat any balances in line with CASS 7 in the way that it would on a business as usual basis. If client positions and money supporting those positions in a client account at a CCP were ported to a back-up clearing member or returned directly to the clients by a CCP, the proposed rules will allow the clearing member to discharge its fiduciary duty regarding those sums ported or returned to the client.

We note firms' comments regarding possible operational changes, though we are not aware of the detail of any changes that may be necessary. We have implemented only those changes necessary to accommodate EMIR.

In response to feedback and following review we are deleting CASS 7A.2.6G as it relates to matters not strictly within the FSA's remit (insolvency law) and is not helpful to firms.

3.21 In CP12/22 we asked:

> ***Q2:*** *Do you agree with our proposed amendments to the client money rules about discharge of client money responsibility, and amending the obligations for notification of trust (CASS 7.8)?*

Discharging client money responsibilities

3.22 Most respondents answering this question agreed with our proposals, although some asked us to clarify exactly when a firm's responsibilities would be extinguished. Some said this should be achieved by modifying the draft rules proposed in CP12/22.

Our response

We have amended our draft rules slightly to provide that a firm's client money obligations will be extinguished when money in a client transaction account at a CCP 'is paid by an authorised central counterparty…in connection with a porting arrangement' or 'is paid by an authorised central counterparty directly to the client…' (CASS 7.2.15R in the attached instrument). This ensures these provisions conform to the other circumstances under which a firm's obligation is discharged. We believe this makes it clear when a firm's obligations will be discharged.

We have made some extra changes to the rules to be clear about discharging client money responsibilities. In the final rules in the Annex, we changed the client money distribution rules in CASS 7A.2.5R that apply when calculating a client's entitlement to the client money pool. These changes make it clear that a firm must reduce a client's client equity balance by any amount which has been ported by a CCP to another clearing member in favour of that client, or any amount the CCP has paid directly to the client or any amount the CCP remits to the firm which is due to be paid directly to the client and does not form part of the client money pool.

Notification of trust

3.23 In CP12/22 we proposed amending the rules on the notification and acknowledgement of trust (or agent in Scotland) contained within CASS 7.8.2. This is so that when a firm's client chooses either omnibus client segregation or individual client segregation, the firm must only notify the CCP that the money the firm will hold in the relevant client transaction account is client money that cannot be combined with any other account and no right of set-off can be exercised by the CCP against any sum owed on another account. This would have been a reduction of the existing notification requirements, which include the requirement to send a notification to, and to receive an acknowledgment from, the CCP.

3.24 The number of responses in favour of the proposed changes and those against was relatively balanced, but slightly more respondents were against the proposed change. There were firms, CCPs and trade associations in both categories.

3.25 Those who opposed the change thought it would create a confusing, two-tiered system in which firms might sometimes be required to obtain an acknowledgement from a CCP, but not in others.

Our response

We agree that changing the rules as proposed could lead to confusion and a two-tier situation. So we have decided not to add CASS 7.8.3R as proposed in CP12/22, but to ensure that the current notification and acknowledgement requirements apply to CCPs authorised or recognised under EMIR. This means that firms will still have to send and receive notification of trust letters in the manner contemplated under the current rules.

We will further consider the wording of CASS 7.8 as part of the wider CASS review.

Transfer of client money to a client transaction account

3.26 In CP12/22 Part I we noted our intention to amend CASS 7.5.3G to make it clear that firms would be permitted to hold excess client money in a client transaction account at a CCP where required to do so under EMIR.

3.27 Some respondents said the proposed drafting was too restrictive.

3.28 In response, we have not amended the existing rule. We have added further guidance to make it clear that it does not apply to client money a firm provides to an EMIR authorised or recognised CCP in connection with client transactions recorded in the firm's client transaction accounts at the CCP.

Annex 1

List of non-confidential respondents

1. Below is a list of non-confidential respondents to those questions from CP12/22 Part I addressed in this PS.

Association of Financial Markets in Europe

Alternative Investment Management Association

British Bankers' Association

BlackRock

Bank of New York Mellon

Clifford Chance

Futures and Options Association

Institute of Chartered Accountants in England and Wales

Investment Management Association

Law Society of England and Wales

London Metal Exchange

NYSE Euronext

PricewaterhouseCoopers LLP

In addition to the above, there were six confidential respondents.

Appendix 1

Made rules (legal instrument)

CLIENT ASSETS SOURCEBOOK (EUROPEAN MARKETS INFRASTRUCTURE REGULATION) INSTRUMENT 2012

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:

(1) section 138 (General rule-making power);
(2) section 139 (Miscellaneous ancillary matters);
(3) section 156 (General supplementary powers); and
(4) section 157(1) (Guidance).

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 January 2013.

Amendments to the Handbook

D. The Glossary of definitions is amended in accordance with Annex A to this instrument.

E. The Client Assets sourcebook (CASS) is amended in accordance with Annex B to this instrument.

Citation

F. This instrument may be cited as the Client Assets Sourcebook (European Markets Infrastructure Regulation) Instrument 2012.

By order of the Board
13 December 2012

Annex A

Amendments to the Glossary of definitions

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

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

authorised central counterparty	a *CCP* authorised or recognised under *EMIR*.
CCP	as defined in article 2(1) of *EMIR*.
EMIR	Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories, sometimes referred to as the "European Markets Infrastructure Regulation".
individual client account	an account maintained by a *firm* at an *authorised central counterparty* for a *client* of the *firm* in respect of which the *authorised central counterparty* has agreed with the *firm* to provide *individual client segregation*.
individual client segregation	as defined in article 39(3) of *EMIR*.
omnibus client account	an account maintained by a *firm* at an *authorised central counterparty* for more than one *client* of the *firm* in respect of which the *authorised central counterparty* has agreed with the *firm* to provide *omnibus client segregation.*
omnibus client segregation	as defined in article 39(2) of *EMIR*.
port	means, in respect of the assets and positions recorded in a *client transaction account* that is an *individual client account* or an *omnibus client account* at an *authorised central counterparty*, action taken by that *authorised central counterparty* to transfer those assets and positions in accordance with article 48 of *EMIR* to another clearing member designated by the individual *client* (in the case of an *individual client account)* or designated by all of the *clients* for whom the account is held (in the case of an *omnibus client account*).

Amend the following as shown.

clearing house	a clearing house through which transactions may be cleared and for the purposes of *CASS* 7 and *CASS* 7A, includes an *authorised central counterparty*.

Annex B

Amendments to the Client Assets sourcebook (CASS)

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

7 Client money rules

…

7.2 Definition of client money

…

7.2.5 G Where a *firm* has received full title or full ownership to *money* under a collateral arrangement, the fact that it has also ~~taken~~ granted a security interest ~~over~~ to its *client* to secure its obligation to repay that *money* to the *client* would not result in the *money* being *client money*. This can be compared to a situation in which a *firm* takes a charge or other security interest over *money* held in a *client bank account*, where that *money* would still be *client money* as there would be no absolute transfer of title to the *firm*. However, ~~if that~~ where a *firm* has received *client money* under a security interest and the security interest includes a "right to use arrangement", under which the *client* agrees to transfer all of its rights to *money* in that account to the *firm* upon the exercise of the right to use, the *money* may cease to be *client money*, but only once the right to use is exercised and the *money* is transferred out of the ~~account~~ *client bank account* to the *firm*.

…

Discharge of fiduciary duty

7.2.15 R *Money* ceases to be *client money* (having regard to *CASS* 7.2.17R where applicable) if ~~it is paid~~:

(1) it is paid to the *client*, or a duly authorised representative of the *client*; or

(2) it is paid to a third party on the instruction of the *client*, unless it is transferred to a third party in the course of effecting a transaction, in accordance with *CASS* 7.5.2R (Transfer of client money to a third party); or

(3) it is paid into a bank account of the *client* (not being an account which is also in the name of the *firm*); or

(4) ~~to the *firm* itself, when~~ it is due and payable to the *firm* ~~(see~~ in accordance with *CASS* 7.2.9R (Money due and payable to the firm)~~)~~; or

(5) it is paid to the *firm* ~~itself, when it is~~ as an excess in the *client bank account* (see *CASS* 7.6.13R(2) (Reconciliation discrepancies)); or

(6) it is paid by an *authorised central counterparty* to a clearing member other than the *firm* in connection with a *porting* arrangement in accordance with *CASS* 7.2.15AR; or

(7) it is paid by an *authorised central counterparty* directly to the *client* in accordance with *CASS* 7.2.15BR.

7.2.15A R *Client money* received or held by the *firm* and placed in a *client transaction account* that is an *individual client account* or an *omnibus client account* at an *authorised central counterparty* ceases to be *client money* for that *firm* if, as part of the default management process of that *authorised central counterparty* in respect of a default by the *firm*, it is *ported* by the *authorised central counterparty* in accordance with article 48 of *EMIR*.

7.2.15B R *Client money* received or held by the *firm* and placed in a *client transaction account* that is an *individual client account* or an *omnibus client account* at an *authorised central counterparty* ceases to be *client money* if, as part of the default management process of that *authorised central counterparty* in respect of a default by the *firm*, it is paid directly to the *client* by the *authorised central counterparty* in accordance with the procedure described in article 48(7) of *EMIR*.

…

7.5 Transfer of client money to a third party

…

7.5.3 G A *firm* should not hold excess *client money* in its *client transaction accounts* with *intermediate brokers*, *settlement agents* and *OTC* counterparties; it should be held in a *client bank account*. This *guidance* does not apply to *client money* provided by a *firm* to an *authorised central counterparty* in connection with a *contingent liability investment* undertaken for a *client* and recorded in a *client transaction account* that is an *individual client account* or an *omnibus client account* at that *authorised central counterparty*.

…

7.8 Notification and acknowledgement of trust

…

Exchanges, clearing houses, intermediary brokers or OTC counterparties

7.8.2 R (1) A *firm* which undertakes any *contingent liability investment* for *clients* through an exchange, *clearing house*, *intermediate broker* or *OTC* counterparty must, before the *client transaction account* is opened with the exchange, *clearing house*, *intermediate broker* or

OTC counterparty:

(a) notify the *person* with whom the account is to be opened that the *firm* is under an obligation to keep *client money* separate from the *firm's* own *money*, placing *client money* in a *client bank account*;

(b) instruct the *person* with whom the account is to be opened that any *money* paid to it in respect of that transaction is to be credited to the *firm's client transaction account*; and

(c) require the *person* with whom the account is to be opened to acknowledge in writing that the *firm's client transaction account* is not to be combined with any other account, nor is any right of set-off to be exercised by that *person* against *money* credited to the *client transaction account* in respect of any sum owed to that *person* on any other account.

(2) If the exchange, *clearing house*, *intermediate broker* or *OTC* counterparty does not provide the required acknowledgement within 20 *business days* of the dispatch of the notice and instruction, the *firm* must cease using the *client transaction account* with that ~~*broker*~~ *clearing house*, *intermediate broker* or *OTC* counterparty and arrange as soon as possible for the transfer or liquidation of any open positions and the repayment of any *money*.

…

7A Client money distribution

…

7A.2 Primary pooling events

…

Pooling and distribution

7A.2.4 R If a *primary pooling event* occurs:

(1) all *client money* held in ~~each *client money* account~~ a *client bank account* or a *client transaction account* of the *firm* is treated as pooled (forming a notional pool) except for *client money* held in a *client transaction account* that is an *individual client account* or an *omnibus client account* at an *authorised central counterparty*; ~~and~~

(2) the *firm* must distribute ~~that~~ *client money* comprising the notional pool in accordance with *CASS* 7.7.2R, so that each *client* receives a sum which is rateable to the *client money* entitlement calculated in accordance with *CASS* 7A.2.5R; and

(3) if *client money* is remitted directly to the *firm* from an *authorised central counterparty*, then:

(a) any such remittance in respect of a *client transaction account* that is an *individual client account* must be distributed to the relevant *client* subject to *CASS* 7.7.2R(4);

(b) subject to (3)(c), any such remittance in respect of a *client transaction account* that is an *omnibus client account* must form part of the notional pool under *CASS* 7A.2.4R(1) and be subject to distribution in accordance with *CASS* 7A.2.4R(2); and

(c) any such remittance in respect of a *client transaction account* that is an *omnibus client account* must be distributed to the *clients* for whom that *omnibus client account* is held if:

(i) no *client money* in excess of the amount recorded in that *omnibus client account* is held by the *firm* as margin in relation to the positions recorded in that *omnibus client account*; and

(ii) the amount of such remittance attributable to each *client* of the *omnibus client account* is readily apparent from information provided to the firm by the *authorised central counterparty*;

in which case the amount of such remittance must be distributed to each such *client* in accordance with the information provided by the *authorised central counterparty* subject to *CASS* 7.7.2R(4).

7A.2.4A G (1) Under *EMIR*, where a *firm* that is a clearing member of an *authorised central counterparty* defaults, the *authorised central counterparty* may:

(a) *port client* positions where possible; and

(b) after the completion of the default management process:

(i) return any balance due directly to those *clients* for whom the positions are held, if they are known to the *authorised central counterparty*; or

(ii) remit any balance to the *firm* for the account of its *clients* if the *clients* are not known to the *authorised central counterparty*.

(2) Where any balance remitted from an *authorised central counterparty* to a *firm* is *client money*, *CASS* 7A.2.4R(3) provides for the distribution of remittances from either an *individual client account* or

an *omnibus client account*.

(3) Remittances received by the *firm* falling within *CASS* 7A.2.4R(3)(a) and *CASS* 7A.2.4R(3)(c) should not be pooled with *client money* held in any *client bank account* operated by the *firm* at the time of the *primary pooling event*. Those remittances should be segregated and promptly distributed to each *client* on whose behalf the remittance was received.

(4) For the avoidance of doubt, any *client money* remitted by the *authorised central counterparty* to the *firm* pursuant to *CASS* 7A.2.4R(3) should not be treated as *client money* received after the failure of the *firm* under *CASS* 7A.2.7R.

7A.2.5 R -(1) Each *client's client equity balance* must be reduced by:

(a) any amount paid by an *authorised central counterparty* to a clearing member other than the *firm* in connection with a *porting* arrangement in accordance with *CASS* 7.2.15R(6) in respect of that *client*;

(b) any amount paid by an *authorised central counterparty* directly to that *client*, in accordance with *CASS* 7.2.15R(7); and

(c) any amount that must be distributed to that *client* by the *firm* in accordance with *CASS* 7A.2.4R (3) (a) or (c).

(1) …

…

7A.2.6 G ~~A *client's* main claim is for the return of *client money* held in a *client bank account*. A *client* may be able to claim for any *shortfall* against *money* held in a *firm's* own account. For that claim, the *client* will be an unsecured creditor of the *firm*.~~ [deleted]

Appendix 2

Designation of Handbook Provisions

2. FSA Handbook provisions will be 'designated' to create a FCA Handbook and a PRA Handbook on the date that the regulators exercise their legal powers to do so. Please visit our website[1] for further details about this process.

3. We plan to designate the Handbook Provisions which we are proposing to create and/or amend within this CP as follows:

Handbook Provision	Designation
All new or amended provisions are in CASS.	We plan to designate all new or amended provisions as FCA provisions.

1 www.fsa.gov.uk/smallfirms/resources/one_minute_guides/about_fsa/handbook-pra-fca.shtml

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