



# WHOLESALE INVESTMENT FIRMS CLIENTS' ASSETS

## SCOPE

Outlines the applicable legislation governing the way in which investment firms hold assets (including cash) belonging to clients.

Informs cryptoasset firms how legislation could apply with respect to providing custody services over clients' assets and the environment in which they do not mix or mistake client assets with or for their own and to ensure that in the event of their insolvency, the clients are in the best possible position as against any other creditors.

## OVERVIEW

Investment firms are subject to strict rules - set down in the Client Assets (CASS) Sourcebook of the Financial Conduct Authority (FCA) Handbook of Rules and Guidance. Whilst these rules seek to minimise any risk of loss to investment firms' clients, they by no means guarantee that clients will not ultimately suffer losses.

The Markets in Financial Instruments Directive (MiFID) had minimal impact on CASS. Irrespective, a number of amendments have been to ensure a speedier return of clients assets and client money in the case of an investment firm's insolvency, including:

limiting the ability for custodians to place lien on custody assets to assets in the same account;

- setting out requirements for prime brokerage agreements;
- resolution processes for client asset and client money holdings; and
- a new way to pool a firm's client money holdings prior to returning it to clients.

An additional important post-MiFID change was the removal of the ability for professional clients to opt out of the client money regime. All professional clients are within scope of the client money regime (unless the relevant firms can make use of the extensive carve-outs from the definition of client money on which the FCA has provided guidance).



One of the main features of the CASS rules is the obligation to inform clients (especially vulnerable clients, such as retail clients) of the potential risk that they face as a result of the firm taking a particular course of action with respect to their assets. The Clients' asset rules are split into three parts: (a) Custody Rules; (b) Collateral; and (c) Client Money.

## CUSTODY RULES

Apply to the regulated activity of safeguarding and administering investments.

Firms need to be aware that they are subject to the custody rules where they use a dedicated custodian, unless the custodian is authorised as such under the Financial Services and Markets Act 2000 (FSMA) or exempt for this purpose and has undertaken to the relevant clients to be accountable for the assets.

Apply to any assets entrusted to the firm as long as they consist of regulated investments.

## SEGREGATION AND INTERNAL CONTROLS

Custody rules are designed to ensure that, in the event of the insolvency of the firm concerned, assets belonging to the firm's clients do not form any part of the pool of assets which are available for distribution to the firm's general (including secured and unsecured) creditors.

Authorities concerning which assets constitute part of an insolvent company's estate establish that in order to exclude assets from an insolvent entity's estate, client assets must be segregated from those belonging to the firm and this must be effectively recorded. Firms are required to send to clients custody statements, indicating the assets which are held, at the minimum on an annual basis, and to conduct a periodical reconciliation of custody investments which are not held by the firm.

Contain specific provisions in connection with the registration and recording of legal title to clients' investments. These require firms to use a number of alternative legal entities for this purpose. For example, a nominee company or a custodian (and to provide, in certain circumstances, risk warnings to affected clients).

## TERMS OF BUSINESS

Conduct of Business (COBS) Sourcebook 6.1.7 contains a list of information which must be provided to a retail client as regards custody (which should be read in light of the requirements in COBS 8 concerning client agreements). Custody terms may form part of the firm's general terms of business or may be provided in a separate document as soon as the firm expects to be providing custody services to clients.

Terms must include comprehensive risk disclosure provisions, especially in respect of regulated investments held with: (a) third-party custodians; and (b) depositories outside the United Kingdom which are subject to different legal and regulatory systems.



## CUSTODY

There are conflicting authorities (resulting in an unsettled legal position) on the question of whether or not non-fungible securities held by a custodian are capable of forming the subject matter of a trust (the issue being the lack of certainty as to the subject matter at any point).

The Custody Rules require an investment firm to have prior written consent from the client before it uses custody investments for its own account (whether for stock lending transactions or otherwise).

## STOCK LENDING

Where an investment firm engages in a stock lending transaction involving securities owned by clients, it must ensure that the borrower provides sufficient collateral at the outset and is obliged to top-up the collateral on a regular basis (otherwise the firm must cover any shortfall).

The Securities Financing Transactions Regulation (SFTR) governs the trade reporting and treatment of collateral for stock lending and repurchase transactions.

## COLLATERAL

Denotes securities which are provided by clients as security for their contingent obligations and which the firm may use (including by way of hypothecation) for the sake of its business.

Unless otherwise agreed, investment firms must monitor the collateral they hold for their clients and maintain appropriate records.

## CLIENT MONEY

Investment firms' conduct in connection with monies placed by, of which are due to, their clients is subject, in the absence of an exemption, to a system of prescriptive rules relating to segregation and internal systems of controls (these rules being subsequently referred to as 'CMR'). Monies which qualify as 'client money' are (unless there is an exemption) subject to a statutory trust for the benefit of the relevant clients.

The most significant exemption from the CMR is that relating to 'approved banks'. This reference includes all United Kingdom deposit-takers and means, in practical terms, that a United Kingdom bank may treat all monies which it receives in the course of conducting securities transactions with or for clients as deposits placed with the bank in the ordinary course of business.

## OPERATIONAL ISSUES

A firm which is subject to the CMR must segregate the firm's own monies from those of its clients and hold client monies in designated bank accounts. Monies should be paid into the designated client account without delay and in the case of an automated transfer system, directly into that account.

There are various requirements relating to dealing with mixed remittances, monitoring of client entitlement to monies, and the payment of interest. Investment firms should, in their terms of business for retail clients, set out the rate of



interest payable on client monies. In the absence of such provisions, they must pay retail clients all interest earned in respect of such monies.

There are further restrictions on the type of bank with which the designated client accounts may be held. However, a firm (other than a trustee firm) may open designated client accounts with a bank which is not an approved bank where the securities transactions are subject to laws and regulations of a country outside the United Kingdom and if, due to legal and regulatory requirements, is impossible to hold client monies with an approved bank. In such case, the firm must notify its clients (and obtain the consent of any retail clients) that client money will not be held with an approved bank, that different regulatory and legal systems would apply from that of the United Kingdom in the event of a bank's failure and, if such is the case, that the bank insists on retaining a right of set-off in connection to the account.

When an investment firm opens a designated client account with a bank (whether or not an approved bank), it must require the bank to acknowledge the special trust relationship which the firm has with its clients in connection with the monies deposited in the accounts. This is designed to ensure that all parties in the chain are aware of the firm's obligations as a trustee and that the funds may not be subject to set-off or counterclaims as they are not the property of the firm. Transfer of client monies to a third-party (e.g. by way of transaction margin) does not discharge the firm from its general obligations under the CMR.

## TRUSTEES

CMR has limited application due to the nature of trustee firms and to avoid a conflict with the terms of a trust document.

The main obligation on trustee firms is to hold client money in accordance with the terms of trust instrument and in any event separate from their own monies.



## HOW CAN WE HELP?

Our services are provided to all cryptoasset ecosystem actors undertaking regulated activities across all of the industry segments, such as Exchange.

Our clients benefit from comprehensive compliance coverage of the United Kingdom's regulatory perimeter, particularly to virtual asset service providers engaged in crypto transfers that are subject to the FATF Travel Rule.

