

Stand out for the right reasons

Protecting Client Assets

July 2014



Shaking up the Client Assets regime



The FCA significantly revised the UK Client Assets protection regime (CASS) when it published Policy Statement 14/9 on 10 June 2014. The revised rules will have a significant impact on banks, brokers and asset managers. It also proposed changes to how ISA managers comply with the CASS regime in Consultation Paper 14/9 on 11 June 2014. We've set out the big issues below.

The revised CASS rules will come into force in stages. Some rules take effect 1 July 2014. On 1 December 2014, rules that require repapering of client documentation come into force. Firms have until 1 June 2015 to implement some of the rules that are likely to require significant IT systems changes.

These rule changes are likely to affect how your business handles client money and assets – including customer relationships, outsourcing arrangements, operations, IT systems, policies and procedures. We strongly recommend that you assess how these changes will affect your business now, and begin planning for implementation. If you would like to discuss how PS 14/9 and CP 14/9 are likely to affect your business, please speak to your PwC contact or one of our CASS specialists listed below.

One of the FCA's key objectives is to make sure that consumers are adequately protected – it sees protecting customer money and assets as fundamental to consumers' rights. The FCA has high expectations of how firms will behave when they agree to protect a client's money or assets.

Protecting client money – changes to client money rules

The changes to the client money rules in CASS 7 affect many aspects of firms' compliance with CASS, including customer relationships, operational arrangements and outsourcing to third parties like banks and administrators.

Segregating client money: Going forward, fewer firms will be able to use the **alternative approach** to segregating client money. The FCA expects that only the largest investment banks use the alternative approach. It plans to restrict the use of the alternative approach by:

- imposing stricter requirements on a firm to demonstrate that it would reduce customer protection if the firm used the normal approach
- only allowing the alternative approach for particular lines of business where the FCA considers it appropriate
- requiring firms to notify the FCA three months before adopting the alternative approach
- requiring firms to operate a mandatory prudent segregation amount to mitigate intraday risk and to obtain a reasonable assurance report from their auditor on the way the firm calculates that amount.

Firms continuing to use the alternative approach will need to reassess its appropriateness at least annually. Some firms currently using the alternative approach will have to switch to the normal approach, and will have a six month period to make the transition.

Firms using the **normal approach** must review their processes to ensure that they receive all client money directly into client bank accounts and not into their own accounts – i.e. client money must be segregated immediately.

Getting reconciliations right: The new rules clarify and codify the standard methods of internal reconciliation. Only certain asset managers will be able to use the **'negative add-back method'** as a standard method of internal client money reconciliation. Other firms will have to get an auditor's letter to do so. The new rules are also more explicit about the required minimum frequency for internal and external client money reconciliations. They tighten up the requirements imposed on firms that use a non-standard method of reconciliation.

Standardising acknowledgement

letters: Formerly known as 'trust letters', the FCA requires firms to have **acknowledgement letters** in place with all banks that hold client money for the firm. It has designated a new template for this purpose, which firms must use.

Tightening the 'DvP' windows: The FCA has restricted the delivery versus payment (DvP) window for purchases and redemptions of units in regulated collective investment schemes to one business day. Firms using the DvP window need to review their processes, systems and controls to ensure that they identify and segregate client money from transactions which aren't settled within this window. As redemption cheques will need to be paid from client money accounts, firms will need to implement a mechanism to segregate redemption proceeds or change their settlement methods. Firms will have to obtain client consent where they intend to rely on the DvP exemption.

Firms relying on the **DvP window** for transactions through a **commercial settlement system** will need to evaluate whether more of their transactions are in the scope of the revised rules. They also may need to repaper client agreements. The FCA has defined 'commercial settlement system' more tightly, and has made it clearer when the window begins. Here too, clients will have to expressly consent to the firm's use of the DvP exemption.

Exemption for deposit takers: The new rules clarify the default position – when banks and other deposit takers hold money for a client that relates to investment business, that money is presumed to be a deposit, and therefore is not client money. Deposit takers that choose not to apply the banking exemption in all circumstances and so hold some (or all) money as client money will need to notify their clients in writing. All deposit takers conducting investment business must analyse and document any instances where their investment business deposits are held as client money, e.g. in respect of custody shortfalls.

Limiting unbreakable term deposits

(UTDs): Firms will only be able to lock up client money in UTDs for a maximum term of 30 days. The rules will permit longer term deposits which are breakable subject to penalty clauses, if the firm can withdraw the money on 30 days' notice. Any penalties must be paid by the firm – the firm can't charge them against the client money account. As a result, firms that currently offer their customers long term UTDs are likely to find that they get lower interest rate returns on client money and customer investment choices.

Unclaimed client money: On a positive note, the FCA is giving firms more flexibility to eliminate trivial balances of **unclaimed client money** by making a payment to charity.

Other clarifications: Helpfully, the rules also clarify areas such as **discharge of fiduciary duty**, **transfer of client money to third parties** and **interest payments**.

Protecting client assets – changes to custody rules

The FCA has also overhauled its custody rules in CASS 6, requiring firms to tighten up their approach to looking after assets held for customers. These changes will have significant operational implications for firms that agree to hold assets for clients.

Custody reconciliations: Firms using integrated systems to record custody assets will be able to adopt an **'internal evaluation method'** for their internal reconciliations. Comparing the total assets held with the sum of the holdings for individual clients seems like a pointless task to many firms, or one which is integrated into the design of their IT systems. Instead firms will be able to demonstrate the completeness and accuracy of their records by showing that their system design and controls are robust.

Written custody agreements: From 1 December 2014, firms will have to formalise all new or materially revised third party custodian arrangements (including any affiliated companies). They have until 1 June 2015 to review and align their existing custody arrangements to comply with the revised rules.

Registering custody assets: Some firms will have to change how they register their own assets, to ensure clear segregation between house and client custody assets.

Dealing with unclaimed custody

assets: Firms will be able to write off unclaimed custody assets if the account has been inactive for 12 years. They will have to pay the proceeds from unclaimed assets to registered charities, and must undertake to make good any subsequent valid claims.

Title transfer collateral arrangements (TTCA)

The FCA has revised both the CASS 6 and CASS 7 rules to permit switching out of TTCA and back into CASS, setting out a prescriptive mechanism intended to give clarity to clients, firms and insolvency practitioners. We expect further changes to be made in this area under MiFID II when it comes into effect in January 2017. The FCA has implemented these provisions based on real-life situations that arose in recent high profile insolvency cases.

Mandates (CASS 8)

Firms will need to apply the mandate rules to recurring authorities that they receive verbally from clients.

Multiple client money pools

The FCA has scaled back from its original proposals, and is now going to limit use of multiple pools to clearing member firms with net omnibus client transaction accounts at central counterparties that are authorised under the European Market Infrastructure Regulation (EMIR).



What should you do now?

The FCA's fundamental revision of CASS sets a new compliance agenda for firms.

- **Scoping:** Undertake a bottom-up review of your client money and assets footprint.
- **Gap Analysis:** Analyse in detail what changes affect your business – identify which products and services, operations, outsource arrangements, etc. are affected. Highlight any unbreakable term deposits issues early, as these changes came in 1 July 2014.
- **Plan for implementation:** Get started on planning for implementation – pull together your project team, develop a detailed project plan and timeline, identify required resources and put appropriate project governance in place.
- **Integrate:** Take an early look at how these changes impact other change programmes that are planned or in progress, especially any relevant IT systems development projects.
- **Execute:** Get started now – time for implementation is short considering the changes affect so many areas.

We can help you structure and implement a change programme to ensure your business implements these important changes effectively and efficiently.

Conclusion

As a result of these changes firms will have to significantly adapt their approach to complying with the CASS rules. The FCA has made it clear that its expectations are high – it has used enforcement action regularly in this area, and is likely to continue to do so. The regulator will be closely scrutinising how well firms comply with the new rules.

And this isn't the end – more change to the CASS regime lies ahead. The FCA plans to consult later this year on its distribution rules for client money and assets, working with HM Treasury to align them to the Special Administration Regime. At the EU level, MiFID II may bring further changes to the UK rules when it comes into force in January 2017.

Meeting the regulator's and clients' high expectations on handling client money and assets will be a challenge – getting started now will help ensure your business meets them.

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The full text of the policy statement is available on the FCA website at:

<http://www.fca.org.uk/static/documents/policy-statements/ps14-09.pdf>

The full text of the ISA consultation paper is available on the FCA website at:

<http://www.fca.org.uk/news/cp14-9-client-money-held-in-individual-savings-accounts>

This publication is also available on PwC website at:

<http://www.pwc.co.uk/protectingclientassets>

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