Applicants
A P Clerk
First Statement
"APC1"
14 May 2009

IN THE HIGH COURT OF JUSTICE **No. 7942 of 2008**

CHANCERY DIVISION

COMPANIES COURT

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (in administration)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

EXHIBIT "APC1"

This is the paginated bundle of copy documents marked "APC1" referred to in the witness statement of ANDREW PETER CLARK dated 14th day of May 2009.

Signed:.....

ANDREW PETER CLARK

14 May 2009

Index to APC1

Lehman companies currently in administration are as follows:

1. Lehman Brothers Holdings Plc

Company Number :	**01854685**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	15 September 2008
Matter Number :	**L-159771**

2. Lehman Brothers International (Europe)

Company Number :	**02538254**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	15 September 2008
Matter Number :	**L-159763**

3. Lehman Brothers Limited

Company Number:	**00846922**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	15 September 2008
Matter Number :	**L-159770**

4. LB UK RE Holdings Limited

Company Number :	**05347966**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis, Dan Yoram Schwarzmann and Graham Hunter Martin (Graham Hunter Martin was appointed on the 29th October 2008)
In Administration From :	15 September 2008
Matter Number :	**L-159764**

001

5. Storm Funding Limited

Company Number :	**02682306**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	23 September 2008
Matter Number :	**L-159982**

6. Mable Commercial Funding Limited

Company Number :	**02682316**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis, Dan Yoram Schwarzmann and Graham Hunter Martin (Graham Hunter Martin was appointed on the 29th October 2008)
In Administration From :	23 September 2008
Matter Number :	**L-159981**

7. Lehman Brothers Europe Limited

Company Number :	**03950078**
Administrators :	Anthony Victor Lomas, Steven Anthony Pearson, Michael John Andrew Jervis and Dan Yoram Schwarzmann
In Administration From :	23 September 2008
Matter Number :	**L-160034**

8. Lehman Brothers UK Holdings Limited

Company Number :	**02074637**
Administrators :	Anthony Victor Lomas, Michael John Andrew Jervis and Derek Anthony Howell
In Administration From :	29 September 2008
Matter Number :	**L-160270**

9. LB SF No.1

Company Number:	**06001928**
Administrators:	Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

002

In Administration From : 2 October 2008
Matter Number : **L-160440**

10. LB UK Financing Ltd

Company Number: **05729776**
Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann
In Administration From : 2 October 2008
Matter Number : **L-160442**

11. Cherry Tree Mortgages Limited

Company Number: **05529374**
Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann
In Administration From: 13 October 2008
Matter Number: **L-160728**

12. Lehman Brothers Lease and Finance No.1 Limited

Company Number: **04387086**
Administrators: Anthony Victor Lomas, Derek Anthony Howell and Michael John Andrew Jervis
In Administration From: 24 October 2008
Matter Number: **L-161287**

13. Zestdew Limited

Company Number: **03752197**
Administrators: Anthony Victor Lomas, Derek Anthony Howell, Dan Yoram Schwarzmann and Graham Hunter Martin.
In Administration From: 29 October 2008
Matter Number: **L-161381**

14. Monaco NPL (No. 1) Limited

Company Number: **05432398**
Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann
In Administration From: 29 October 2008

Matter Number: **L-161418**

15. Lehman Commercial Mortgage Conduit Limited

Company Number: **06221756**

Administrators: Anthony Victor Lomas, Derek Anthony Howell, Dan Yoram Schwarzmann and Graham Hunter Martin

In Administration From: 30 October 2008

Matter Number: **L-161442**

16. LB RE Financing No.3 Limited

Company Number: **06454161**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From: 30 October 2008

Matter Number: **L-161419**

17. Lehman Brothers (PTG) Limited

Company Number: **04108157**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From: 6 November 2008

Matter Number: **L-161711**

18. Eldon Street Holdings Limited

Company Number: **04108165**

Administrators: Anthony Victor Lomas, Derek Anthony Howell and Dan Yoram Schwarzmann

In Administration From: 9 December 2008

Matter Number: **L-162936**

19. LB Holdings Intermediate 2 Limited

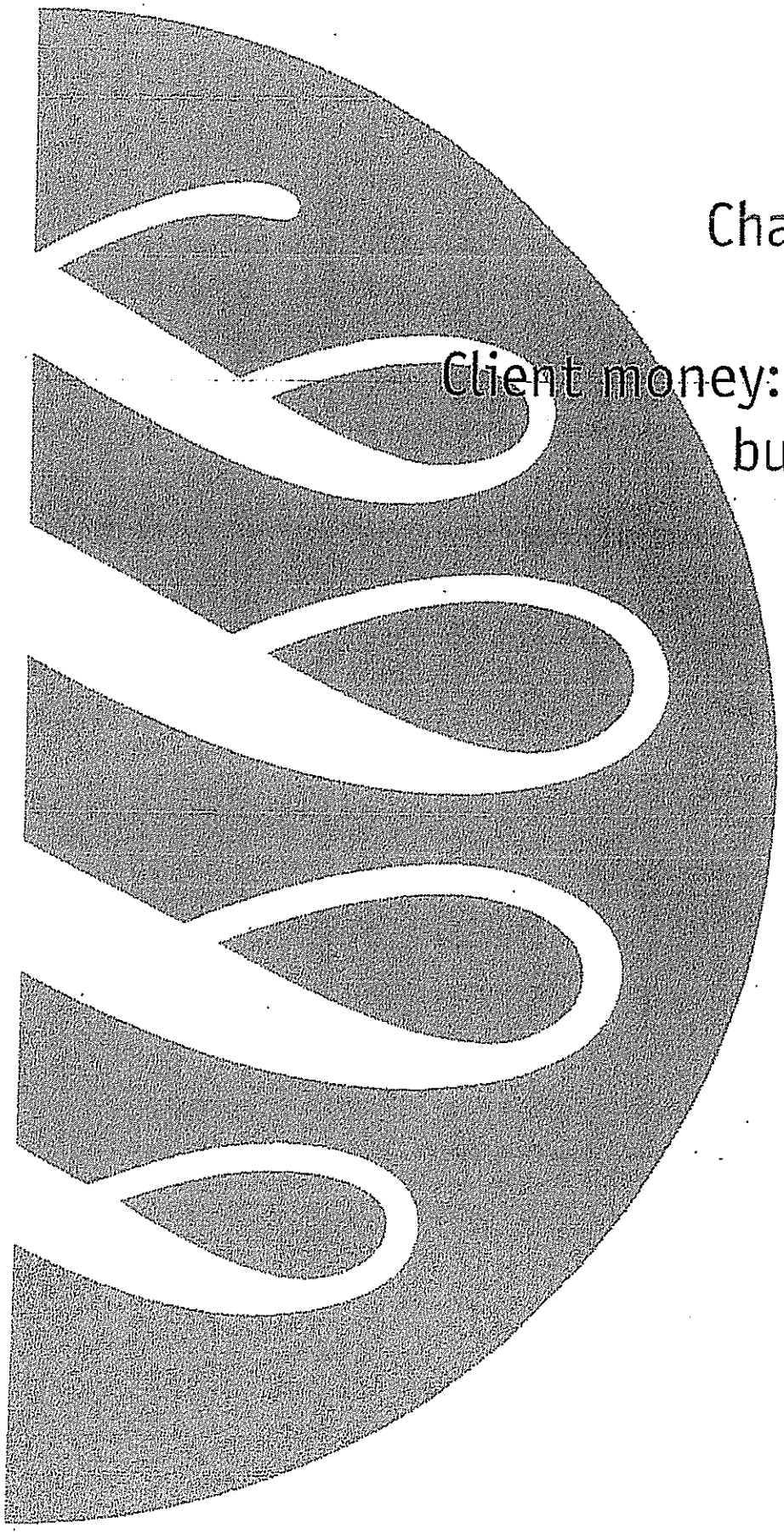
Company Number: **05957878**

Administrators: Anthony Victor Lomas, Steven Anthony Pearson, Derek Anthony Howell and Michael John Andrew Jervis

In Administration From: 14 January 2009

Chapter 7

Client money: MiFID business



7.1 Application and Purpose

Application

7.1.1 R This chapter (the *client money rules*) applies to :

(1) a *MiFID investment firm*:

(a) that holds *client money*; or

(b) that opts to comply with this chapter in accordance with ■ CASS 7.1.3 R (1) (Opt-in to the MiFID client money rules); and

(2) a *third country investment firm* that opts to comply with this chapter in accordance with ■ CASS 7.1.3 R (2) (Opt-in to the MiFID client money rules);

unless otherwise specified in this section.

7.1.2 G ■ CASS 7.2 (Definition of client money) sets out the circumstances in which *money* is considered *client money* for the purposes of this chapter.

Opt-in to the MiFID client money rules

7.1.3 R (1) A *firm* that receives or holds *money* in respect of which this chapter applies and *money* in respect of which the *non-directive client money chapter* or the *insurance client money chapter* applies, may elect to comply with the provisions of this chapter in respect of all such *money* and if it does so, this chapter applies as if all such *money* were *money* that the *firm* receives and holds in the course of, or in connection with, its *MiFID business*.

(1A) A *third country investment firm* that receives or holds *money* from, for or on behalf of a *client* in the course of, or in connection with, its *equivalent business of a third country investment firm* may elect to comply with the provisions of this chapter in respect of the *money* it holds to which the *non-directive client money chapter* or the *insurance client money chapter* applies. If it does so, this chapter applies as if

all such *money* were *money* that the *firm* receives and holds in the course of, or in connection with, *MiFID business*.

(2) A *firm* must make and retain a written record of any election it makes under this *rule*, including the date from which the election is to be effective. The *firm* must make the record on the date it makes the election and must keep it for a period of five years after ceasing to use it.

7.1.4 G The opt-in to the *client money rules* in this chapter does not apply in respect of *money* that a *firm* holds outside of the scope of the *non-directive client money chapter* or the *insurance client money chapter* , such as *money* falling within the scope of the opt-out for *non-IMD designated investment business* (see ■ CASS 4.1.11 R).

7.1.5 G If a *firm* has opted to comply with this chapter, the *non-directive client money chapter* or the *insurance client money chapter* will have no application to the activities to which the election applies.

7.1.6 G A *firm* (other than a *third country investment firm*) that is only subject to the *non-directive client money chapter* or the *insurance client money chapter* may not opt to comply with this chapter.

7.1.7 G If a *firm* that has agreed with an *insurance undertaking* under the *client money rules* in the *insurance client money chapter* to treat the undertaking's *money* as *client money*, opts in to this chapter in accordance with this section, the *insurance undertaking's* interest under the trust (or in Scotland agency) will be subordinated to the interests of the *firm's* other *clients*.

7.1.7A G The information requirements concerning the safeguarding of *client money* (see ■ COBS 6.1.7 R) apply to a *firm* that has elected to comply with this chapter with respect of all *client money* to which the election applies.

Credit institutions

7.1.8 R The *client money rules* do not apply to a *BCD credit institution* in relation to deposits within the meaning of the *BCD* held by that *institution*.

[Note: article 13(8) of *MiFID* and article 18(1) of the *MiFID implementing Directive*]

7.1.9 G If a *credit institution* that holds *money* as a deposit with itself is subject to the *requirement to disclose information before providing services*, it should, in compliance with that obligation, notify the *client* that:

(1) *money* held for that *client* in an account with the *credit institution* will be held by the *firm* as banker and not as trustee (or in Scotland as agent); and

(2) as a result, the *money* will not be held in accordance with the *client money rules*.

7.1.10 G Pursuant to *Principle* 10 (Clients' assets), a *credit institution* that holds *money* as a deposit with itself should be able to account to all of its *clients* for amounts held on their behalf at all times. A bank account opened with the *firm* that is in the name of the *client* would generally be sufficient. When *money* from *clients* deposited with the *firm* is held in a pooled account, this account should be clearly identified as an account for *clients*. The *firm* should also be able to demonstrate that an amount owed to a specific *client* that is held within the pool can be reconciled with a record showing that individual's *client* balance and is, therefore, identifiable at any time. Similarly, where that *money* is reflected only in a *firm's* bank account with other banks (nostro accounts), the *firm* should be able to reconcile amounts owed to that *client* within a reasonable period of time.

7.1.11 G A *credit institution* is reminded that the exemption for deposits is not an absolute exemption from the *client money rules*.

Affiliated companies

7.1.12 G A *firm* that holds *money* on behalf of, or receives *money* from, an *affiliated company* in respect of *MiFID business* must treat the *affiliated company* as any other *client* of the *firm* for the purposes of this chapter.

7.1.13 G A *firm* that holds *client money* on behalf of, or receives *money* from, an *affiliated company* in respect of its *non-MiFID business* and opts under ■ CASS 7.1.3 R (1) to comply with this chapter in with respect of that *non-MiFID business*, should refer to the *non-directive client money chapter* (see ■ CASS 4.1.18 R (Affiliated companies)) to determine whether that money falls within the scope of the non-directive client money chapter and therefore within the scope of the opt-in.

Coins

7.1.14 R The *client money rules* do not apply with respect to coins held on behalf of a *client* if the *firm* and the *client* have agreed that the *money* (or *money* of that type) is to be held by the *firm* for the intrinsic value of the metal which constitutes the coin.

Solicitors

7.1.15 R (1) An *authorised professional firm* regulated by the Law Society (of England and Wales), the Law Society of Scotland or the Law Society of Northern Ireland must comply with the *MiFID client money (minimum implementing) rules* and also with the following rules of its *designated professional body* and if it does so, it will be deemed to comply with the *client money rules* in this chapter.

(2) The relevant rules are:

(a) if the *firm* is regulated by the Law Society (of England and Wales):

(i) the Solicitors' Accounts Rules 1998; or

(ii) where applicable, the Solicitors Overseas Practice Rules 1990;

(b) if the *firm* is regulated by the Law Society of Scotland, the Solicitors' (Scotland) Accounts, Accounts Certificate, Professional Practice and Guarantee Fund Rules 2001; and

(c) if the *firm* is regulated by the Law Society of Northern Ireland, the Solicitors' Accounts Regulations 1998.

General purpose

7.1.16 G

(1) *Principle* 10 (Clients' assets) requires a *firm* to arrange adequate protection for *clients'* assets when the *firm* is responsible for them. An essential part of that protection is the proper accounting and treatment of *client money*. The *client money rules* provide requirements for *firms* that receive or hold *client money*, in whatever form.

(2) The *client money rules* also implement the provisions of *MiFID* which regulate the obligations of a *firm* when it holds *client money*.

7.2 Definition of client money

7.2.1 R For the purposes of this chapter and the *MiFID custody chapter*, *client money* means any *money* that a *firm* receives from or holds for, or on behalf of, a *client* in the course of, or in connection with, its *MiFID business* unless otherwise specified in this section.

Business in the name of the firm

7.2.2 R *Money* is not *client money* where the *firm* carries on business in its own name on behalf of the *client* where that is required by the very nature of the transaction and the *client* is in agreement.

[Note: recital 26 to *MiFID*]

Title transfer collateral arrangements

7.2.3 R 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, such *money* should no longer be regarded as *client money*.

[Note: recital 27 to *MiFID*]

7.2.4 G A title transfer financial collateral arrangement under the *Financial Collateral Directive* is an example of a type of transfer of *money* to cover obligations where that *money* will not be regarded as *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 a security interest over 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 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 to the *firm*.

7.2.6 G *Firms* are reminded of the *client's best interest rule*, which requires a *firm* to act honestly, fairly and professionally in accordance with the best interests of its *clients*

when structuring its business particularly in respect of the effect of that structure on *firms'* obligations under the *client money rules*.

7.2.7 G Pursuant to the *client's best interests rule*, a *firm* should ensure that where a *retail client* transfers full ownership of *money* to a *firm*:

(1) the *client* is notified that full ownership of the *money* has been transferred to the *firm* and, as such, the *client* no longer has a proprietary claim over this *money* and the *firm* can deal with it on its own right;

(2) the transfer is for the purposes of securing or covering the *client's* obligations;

(3) an equivalent transfer is made back to the *client* if the provision of collateral by the *client* is no longer necessary; and

(4) there is a reasonable link between the timing and the amount of the collateral transfer and the obligation that the *client* owes, or is likely to owe, to the *firm*.

Money in connection with a "delivery versus payment" transaction

7.2.8 R *Money* need not be treated as *client money* in respect of a delivery versus payment transaction through a commercial settlement system if it is intended that either:

(1) in respect of a *client's* purchase, *money* from a *client* will be due to the *firm* within one *business day* upon the fulfilment of a delivery obligation; or

(2) in respect of a *client's* sale, *money* is due to the *client* within one *business day* following the *client's* fulfilment of a delivery obligation;

unless the delivery or payment by the *firm* does not occur by the close of business on the third *business day* following the date of payment or delivery of the *investments* by the *client*.

Money due and payable to the firm

7.2.9 R (1) *Money* is not *client money* when it becomes properly due and payable to the *firm* for its own account.

(2) For these purposes, if a *firm* makes a payment to, or on the instructions of, a *client*, from an account other than a *client bank account*, until that payment has cleared, no equivalent sum from a client bank account for reimbursement will become due and payable to the *firm*.

7.2.10 G *Money* held as *client money* becomes due and payable to the *firm* or for the *firm's* own account, for example, because the *firm* acted as *principal* in the contract or the *firm*, acting as agent, has itself paid for *securities* in advance of receiving the purchase *money* from its *client*. The circumstances in which it is due and payable will depend on the contractual arrangement between the *firm* and the *client*.

7.2.11 G When a *client's* obligation or liability, that is secured by that *client's* asset, crystallises, and the *firm* realises the asset in accordance with an agreement entered into between the *client* and the *firm*, the part of the proceeds of the asset to cover such liability that is due and payable to the *firm* is not *client* money. However, any proceeds of sale in excess of the amount owed by the *client* to the *firm* should be paid over to the *client* immediately or be held in accordance with the *client money rules*.

Commission rebate

7.2.12 G When a *firm* has entered into an arrangement under which *commission* is rebated to a *client*, those rebates need not be treated as *client money* until they become due and payable to the *client* in accordance with the terms of the contractual arrangements between the parties.

7.2.13 G When *commission* rebate becomes due and payable to the *client*, the *firm* should:

(1) treat it as *client money*; or

(2) pay it out in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (see ■ CASS 7.2.15 R);

unless the *firm* and the *client* have entered into an arrangement under which the *client* has agreed to transfer full ownership of this *money* to the *firm* as collateral against payment of future professional fees (see ■ CASS 7.2.3 R (Title transfer collateral arrangements)).

Interest

7.2.14 R Unless a *firm* notifies a *retail client* in writing whether or not interest is to be paid on *client money* and, if so, on what terms and at what frequency, it must pay that *client* all interest earned on that *client money*. Any interest due to a *client* will be *client money*.

Discharge of fiduciary duty

7.2.15 R *Money* ceases to be *client money* if it is paid:

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

(2) 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 7.5.2 R (Transfer of client money to a third party); or

(3) 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 ■ CASS 7.2.9 R (Money due and payable to the firm)); or

(5) to the *firm* itself, when it is an excess in the *client bank account* (see ■ CASS 7.6.13 R (2) (Reconciliation discrepancies)).

7.2.16 G When a *firm* wishes to transfer *client money* balances to a third party in the course of transferring its business to another *firm*, it should do so in a way which it discharges its fiduciary duty to the *client* under this section.

7.2.17 R When a *firm* draws a cheque or other payable order to discharge its fiduciary duty to the *client*, it must continue to treat the sum concerned as *client money* until the cheque or order is presented and paid by the bank.

Allocated but unclaimed client money

7.2.18 G The purpose of the *rule* on allocated but unclaimed *client money* is to allow a *firm*, in the normal course of its business, to cease to treat as *client money* any balances, allocated to an individual *client*, when those balances remain unclaimed.

7.2.19 R A *firm* may cease to treat as *client money* any unclaimed *client money* balance if it can demonstrate that it has taken reasonable steps to trace the *client* concerned and to return the balance.

7.2.20 (1) Reasonable steps should include:

(a) entering into a written agreement, in which the *client* consents to the *firm* releasing, after the period of time specified in (b), any *client money* balances, for or on behalf of that *client*, from *client bank accounts*;

(b) determining that there has been no movement on the *client's* balance for a period of at least six years (notwithstanding any payments or receipts of charges, interest or similar items);

(c) writing to the *client* at the last known address informing the *client* of the *firm's* intention of no longer treating that balance as *client money*, giving the *client* 28 days to make a claim;

(d) making and retaining records of all balances released from *client bank accounts*; and

(e) undertaking to make good any valid claim against any released balances.

(2) Compliance with (1) may be relied on as tending to establish compliance with ■ CASS 7.2.19 R.

(3) Contravention of (1) may be relied on as tending to establish contravention of ■ CASS 7.2.19 R.

7.2.21 G When a *firm* gives an undertaking to make good any valid claim against released balances, it should make arrangements authorised by the *firm's* relevant *controllers* that are legally enforceable by any *person* with a valid claim to such *money*.

7.3 Organisational requirements: client money

Requirement to protect client money

7.3.1 R A *firm* must, when holding *client money*, make adequate arrangements to safeguard the *client's* rights and prevent the use of *client money* for its own account.

[Note: article 13(8) of *MiFID*]

Requirement to have adequate organisational arrangements

7.3.2 R A *firm* must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of *client money*, or of rights in connection with *client money*, as a result of misuse of *client money*, fraud, poor administration, inadequate record-keeping or negligence.

[Note: article 16(1)(f) of the *MiFID implementing Directive*]

7.4 Segregation of client money

Depositing client money

7.4.1 R A *firm*, on receiving any *client money*, must promptly place this *money* into one or more accounts opened with any of the following:

(1) a central bank;

(2) a *BCD credit institution*;

(3) a bank authorised in a third country;

(4) a *qualifying money market fund*.

[Note: article 18(1) of the *MiFID implementing Directive*]

7.4.2 G An account with a central bank, a *BCD credit institution* or a bank authorised in a third country in which *client money* is placed is a *client bank account*.

Qualifying money market funds

7.4.3 G Where a *firm* deposits *client money* with a *qualifying money market fund*, the units in that fund should be held in accordance with the *MiFID custody chapter*.

[Note: recital 23 to the *MiFID implementing Directive*]

7.4.4 G A *firm* that places *client money* in a *qualifying money market fund* should ensure that it has the *permissions* required to invest in and hold units in that fund and must comply with the *rules* that are relevant for those activities.

7.4.5 R A *firm* must give a *client* the right to oppose the placement of his *money* in a *qualifying money market fund*.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.6 G If a *firm* that intends to place *client money* in a *qualifying money market fund* is subject to the *requirement to disclose information before providing services*, it should, in compliance with that obligation, notify the *client* that:

(1) *money* held for that *client* will be held in a *qualifying money market fund*; and

(2) as a result, the *money* will not be held in accordance with the *client money rules* but in accordance with the *custody rules*.

A firm's selection of a credit institution, bank or money market fund

7.4.7 R A *firm* that does not deposit *client money* with a central bank must exercise all due skill, care and diligence in the selection, appointment and periodic review of the *credit institution*, bank or *qualifying money market fund* where the *money* is deposited and the arrangements for the holding of this *money*.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.8 R When a *firm* makes the selection, appointment and conducts the periodic review of a *credit institution*, a bank or a *qualifying money market fund*, it must take into account:

(1) the expertise and market reputation of the third party; and

(2) any legal requirements or market practices related to the holding of *client money* that could adversely affect *clients'* rights.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.9 G In discharging its obligations when selecting, appointing and reviewing the appointment of a *credit institution*, a bank or a *qualifying money market fund*, a *firm* should also consider, together with any other relevant matters:

(1) the need for diversification of risks;

(2) the capital of the *credit institution* or bank;

(3) the amount of *client money* placed, as a proportion of the *credit institution* or bank's capital and *deposits*, and, in the case of a *qualifying money market fund*, compared to any limit the fund may place on the volume of redemptions in any period;

(4) the credit rating of the *credit institution* or bank; and

(5) to the extent that the information is available, the level of risk in the investment and loan activities undertaken by the *credit institution* or bank and *affiliated companies*.

7.4.10 R A *firm* must make a record of the grounds upon which it satisfies itself as to the appropriateness of its selection of a *credit institution*, a bank or a *qualifying money market fund*. The *firm* must make the record on the date it makes the selection and must keep it from the date of such selection until five years after the *firm* ceases to use the third party to hold *client money*.

Client bank accounts

7.4.11 R A *firm* must take the necessary steps to ensure that *client money* deposited, in accordance with ■ CASS 7.4.1 R, in a central bank, a *credit institution*, a bank authorised in a third country or a *qualifying money market fund* is held in an account or accounts identified separately from any accounts used to hold *money* belonging to the *firm*.

[Note: article 16(1)(e) of the *MiFID implementing Directive*]

7.4.12 G A *firm* may open one or more *client bank accounts* in the form of a *general client bank account*, a *designated client bank account* or a *designated client fund account* (see ■ CASS 7.9.3 G).

7.4.13 G A *designated client fund account* may be used for a *client* only where that *client* has consented to the use of that account and all other *designated client fund accounts* which may be pooled with it. For example, a *client* who consents to the use of bank A and bank B should have his *money* held in a different *designated client fund account* at bank B from a *client* who has consented to the use of banks B and C.

Payment of client money into a client bank account

7.4.14 G Two approaches that a *firm* can adopt in discharging its obligations under the *MiFID client money segregation requirements* are:

(1) the 'normal approach'; or

(2) the 'alternative approach'.

7.4.15 R A *firm* that does not adopt the normal approach must first send a written confirmation to the *FSA* from the *firm*'s auditor that the *firm* has in place systems and controls which are adequate to enable it to operate another approach effectively.

7.4.16 G The alternative approach would be appropriate for a *firm* that operates in a multi-product, multi-currency environment for which adopting the normal approach would be unduly burdensome and would not achieve the *client* protection objective. Under the alternative approach, *client money* is received into and paid out of a *firm*'s own bank accounts; consequently the *firm* should have systems and controls that are capable of monitoring the *client money* flows so that the *firm* comply with its obligations to perform reconciliations of records and accounts (see ■ CASS 7.6.2 R). A *firm* that adopts the alternative approach will segregate *client money* into a *client bank account* on a daily basis, after having performed a reconciliation of records and accounts of the entitlement of each *client* for whom the *firm* holds *client money* with the records and accounts of the *client money* the *firm* holds in *client bank account* and *client transaction accounts* to determine what the *client money* requirement was at the close of the previous *business day*.

7.4.17 G Under the normal approach, a *firm* that receives *client money* should either:

(1) pay it promptly, and in any event no later than the next *business day* after receipt, into a *client bank account*; or

(2) pay it out in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (see CASS 7.2.15 R).

7.4.18 G Under the alternative approach, a *firm* that receives *client money* should:

(1) (a) pay any *money* to or on behalf of *clients* out of its own account; and

(b) perform a reconciliation of records and accounts required under CASS 7.6.2 R (Records and accounts), SYSC 4.1.1 R and SYSC 6.1.1 R, adjust the balance held in its *client bank accounts* and then segregate the *money* in the *client bank account* until the calculation is re-performed on the next *business day*; or

(2) pay it out in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (see CASS 7.2.15 R).

7.4.19 G A *firm* that adopts the alternative approach may:

(1) receive all *client money* into its own bank account;

(2) choose to operate the alternative approach for some types of business (for example, overseas equities transactions) and operate the normal approach for other types of business (for example, *contingent liability investments*) if the *firm* can demonstrate that its systems and controls are adequate (see CASS 7.4.15 R); and

(3) use an historic average to account for uncleared cheques (see paragraph 4 of CASS 7 Annex 1 G).

7.4.20 G Pursuant to the *MiFID client money segregation requirements*, a *firm* should ensure that any *money* other than *client money* deposited in a *client bank account* is promptly paid out of that account unless it is a minimum sum required to open the account, or to keep it open.

7.4.21 R If it is prudent to do so to ensure that *client money* is protected, a *firm* may pay into a *client bank account money* of its own, and that *money* will then become *client money* for the purposes of this chapter.

Automated transfers

7.4.22 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach that receives *client money* in the form of an automated transfer should take reasonable steps to ensure that:

(1) the *money* is received directly into a *client bank account*; and

(2) if *money* is received directly into the *firm's* own account, the *money* is transferred into a *client bank account* promptly, and in any event, no later than the next *business day* after receipt.

Mixed remittance

7.4.23 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach that receives a *mixed remittance* (that is part *client money* and part other *money*) should:

(1) pay the full sum into a *client bank account* promptly, and in any event, no later than the next *business day* after receipt; and

(2) pay the *money* that is not *client money* out of the *client bank account* promptly, and in any event, no later than one *business day* of the day on which the *firm* would normally expect the remittance to be cleared.

Appointed representatives, tied agents, field representatives and other agents

7.4.24 G (1) Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach should establish and maintain procedures to ensure that *client money* received by its *appointed representatives*, *tied agents*, *field representatives* or other agents is:

(a) paid into a *client bank account* of the *firm* promptly, and in any event, no later than the next *business day* after receipt; or

(b) forwarded to the *firm*, or in the case of a *field representative* forwarded to a specified business address of the *firm*, so as to ensure that the *money* arrives at the specified business address promptly, and in any event, no later than the close of the third *business day*.

(2) For the purposes of 1(b), *client money* received on *business day* one should be forwarded to the *firm* or specified business address of the *firm* promptly, and in any event, no later than the next *business day* after receipt (*business day* two) in order for it to reach that *firm* or specified business address by the close of the third *business day*. Procedures requiring the *client money* in the form of a cheque to be sent to the *firm* or the specified business address of the *firm* by first class post promptly, and in any event, no later than the next *business day* after receipt, would be in line with 1(b).

7.4.25 G The *firm* should ensure that its *appointed representatives*, *tied agents*, *field representatives* or other agents keep *client money* separately identifiable from any other *money* (including that of the *firm*) until the *client money* is paid into a *client bank account* or sent to the *firm*.

7.4.26 G A *firm* that operates a number of small branches, but holds or accounts for all *client money* centrally, may treat those small branches in the same way as *appointed representatives* and *tied agents*.

Client entitlements

7.4.27 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach that receives outside the *United Kingdom* a *client* entitlement on behalf of a *client* should pay any part of it which is *client money*:

(1) to, or in accordance with, the instructions of the *client* concerned; or

(2) into a *client bank account* promptly, and in any event, no later than five *business days* after the *firm* is notified of its receipt.

7.4.28 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach should allocate a *client* entitlement that is *client money* to the individual *client* promptly and, in any case, no later than ten *business days* after notification of receipt.

Money due to a client from a firm

7.4.29 G Pursuant to the *MiFID client money segregation requirements*, a *firm* operating the normal approach that is liable to pay *money* to a *client* should promptly, and in any event no later than one *business day* after the *money* is due and payable, pay the *money*:

(1) to, or to the order of, the *client*; or

(2) into a *client bank account*.

Segregation in different currency

7.4.30 R A *firm* may segregate *client money* in a different currency from that of receipt. If it does so, the *firm* must ensure that the amount held is adjusted each *day* to an amount at least equal to the original currency amount (or the currency in which the *firm* has its liability to its *clients*, if different), translated at the previous day's closing spot exchange rate.

7.4.31 G The *rule* on segregation of *client money* in a different currency (CASS 7.4.30 R) does not apply where the *client* has instructed the *firm* to convert the *money* into and hold it in a different currency.

Commodity Futures Trading Commission Part 30 exemption order

7.4.32 G United States (US) legislation restricts the ability of non-US firms to trade on behalf of US customers on non-US futures and options exchanges. The relevant US regulator (the *CFTC*) operates an exemption system for *firms* authorised by the *FSA*. The *FSA* sponsors the application from a *firm* for exemption from Part 30 of the General Regulations under the US Commodity Exchange Act in line with this system. The application forms and associated information can be found on the *FSA* website in the "Forms" section.

7.4.33 G A *firm* with a *Part 30 exemption order* undertakes to the *CFTC* that it will refuse to allow any US customer to opt not to have his *money* treated as *client money* if it is held or received in respect of transactions on non-US exchanges, unless that US customer is an "eligible contract participant" as defined in section 1a(12) of the Commodity Exchange Act, 7 U.S.C. The *MiFID client money chapter* does not have the option of allowing the *firm* or the *client* to choose whether *money* belonging to the *client* is subject to the *client money rules*.

7.4.34 R A *firm* must not reduce the amount of, or cancel a letter of credit issued under, an LME bond arrangement where this will cause the *firm* to be in breach of its *Part 30 exemption order*.

7.4.35 R A *firm* must notify the *FSA* immediately it arranges the *issue* of an individual letter of *credit* under an LME bond arrangement.

7.5 Transfer of client money to a third party

7.5.1 G This section sets out the requirements a *firm* must comply with when it transfers *client money* to another *person* without discharging its fiduciary duty owed to that *client*. Such circumstances arise when, for example, a *firm* passes *client money* to a *clearing house* in the form of margin for the *firm's* obligations to the *clearing house* that are referable to transactions undertaken by the *firm* for the relevant clients. They may also arise when a *firm* passes *client money* to an *intermediate broker* for *contingent liability investments* in the form of initial or variation margin on behalf of a *client*. In these circumstances, the *firm* remains responsible for that *client's equity balance* held at the *intermediate broker* until the contract is terminated and all of that *client's* positions at that *broker* closed. If a *firm* wishes to discharge itself from its fiduciary duty, it should do so in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (■ CASS 7.2.15 R).

7.5.2 R A *firm* may allow another *person*, such as an exchange, a *clearing house* or an *intermediate broker*, to hold or control *client money*, but only if:

(1) the *firm* transfers the *client money*:

(a) for the purpose of a transaction for a *client* through or with that *person*; or

(b) to meet a *client's* obligation to provide collateral for a transaction (for example, an *initial margin* requirement for a *contingent liability investment*); and

(2) in the case of a *retail client*, that *client* has been notified that the *client money* may be transferred to the other *person*.

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*.

7.6 Records, accounts and reconciliations

Records and accounts

7.6.1 R A *firm* must keep such records and accounts as are necessary to enable it, at any time and without delay, to distinguish *client money* held for one *client* from *client money* held for any other *client*, and from its own *money*.

[Note: article 16(1)(a) of the *MiFID implementing Directive*]

7.6.2 R A *firm* must maintain its records and accounts in a way that ensures their accuracy, and in particular their correspondence to the *client money* held for *clients*.

[Note: article 16(1)(b) of the *MiFID implementing Directive*]

Client entitlements

7.6.3 G Pursuant to CASS 7.6.2 R, SYSC 4.1.1 R and SYSC 6.1.1 R, a *firm* should take reasonable steps to ensure that is notified promptly of any receipt of *client money* in the form of a *client* entitlement.

Record keeping

7.6.4 R A *firm* must ensure that records made under CASS 7.6.1 R and CASS 7.6.2 R are retained for a period of five years after they were made.

7.6.5 G A *firm* should ensure that it makes proper records, sufficient to show and explain the *firm's* transactions and commitments in respect of its *client money*.

Internal reconciliations of client money balances

7.6.6 G (1) SYSC 4.1.1 R requires *firms* to have robust governance arrangements, such as internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems. In addition, SYSC 6.1.1 R requires *firms* to establish, implement and maintain adequate policies and procedures sufficient to ensure the *firm's* compliance with its obligations under the *regulatory system*. Carrying out internal reconciliations of records and accounts of the entitlement of each *client* for whom the *firm* holds *client money* with the records and accounts of the *client money* the *firm* holds in *client bank accounts* and *client transaction*

accounts should be one of the steps a *firm* takes to satisfy its obligations under CASS 7.6.2 R, SYSC 4.1.1 R and SYSC 6.1.1 R.

(2) A *firm* should perform such internal reconciliations:

(a) as often as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of the *firm's* records and accounts.

(3) The *standard method of internal client money reconciliation* sets out a method of reconciliation of client money balances that the *FSA* believes should be one of the steps that a *firm* takes when carrying out internal reconciliations of *client money*.

Records

7.6.7 R (1) A *firm* must make records, sufficient to show and explain the method of internal reconciliation of *client money* balances under CASS 7.6.2 R used, and if different from the *standard method of internal client money reconciliation*, to show and explain that:

(a) the method of internal reconciliation of *client money* balances used affords an equivalent degree of protection to the *firm's clients* to that afforded by the *standard method of internal client money reconciliation*; and

(b) in the event of a *primary pooling event* or a *secondary pooling event*, the method used is adequate to enable the *firm* to comply with the *client money (MiFID business) distribution rules*.

(2) A *firm* must make these records on the date it starts using a method of internal reconciliation of *client money* balances and must keep it made for a period of five years after ceasing to use it.

7.6.8 R A *firm* that does not use the *standard method of internal client money reconciliation* must first send a written confirmation to the *FSA* from the *firm's* auditor that the *firm* has in place systems and controls which are adequate to enable it to use another method effectively.

Reconciliations with external records

7.6.9 R A *firm* must conduct, on a regular basis, reconciliations between its internal accounts and records and those of any third parties by whom *client money* is held.

[Note: article 16(1)(c) of the *MiFID implementing Directive*]

Frequency of external reconciliations

7.6.10 G

(1) A *firm* should perform the required reconciliation of *client money* balances with external records:

(a) as regularly as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of its internal accounts and records against those of third parties by whom *client money* is held.

(2) In determining whether the frequency is adequate, the *firm* should consider the risks which the business is exposed, such as the nature, volume and complexity of the business, and where and with whom the *client money* is held.

Method of external reconciliations

7.6.11 G

A method of reconciliation of *client money* balances with external records that the *FSA* believes is adequate is when a *firm* compares:

(1) the balance on each *client bank account* as recorded by the *firm* with the balance on that account as set out on the statement or other form of confirmation issued by the bank with which those accounts are held; and

(2) the balance, currency by currency, on each *client transaction account* as recorded by the *firm*, with the balance on that account as set out in the statement or other form of confirmation issued by the *person* with whom the account is held;

and identifies any discrepancies between them.

7.6.12 R

Any *approved collateral* held in accordance with the *client money rules* must be included within this reconciliation.

Reconciliation discrepancies

7.6.13 R

When any discrepancy arises as a result of a *firm's* internal reconciliations, the *firm* must identify the reason for the discrepancy and ensure that:

(1) any *shortfall* is paid into a *client bank account* by the close of business on the day that the reconciliation is performed; or

(2) any excess is withdrawn within the same time period (but see ■ CASS 7.4.20 G and ■ CASS 7.4.21 R).

7.6.14 R

When any discrepancy arises as a result of the reconciliation between a *firm's* internal records and those of third parties that hold *client money*, the *firm* must identify the reason for the discrepancy and correct it as soon as possible, unless the discrepancy arises solely as a result of timing differences between the accounting systems of the party providing the statement or confirmation and that of the *firm*.

7.6.15 R

While a *firm* is unable to resolve a difference arising from a reconciliation between a *firm's* internal records and those of third parties that hold *client*

money, and one record or a set of records examined by the *firm* during its reconciliation indicates that there is a need to have a greater amount of *client money* or *approved collateral* than is in fact the case, the *firm* must assume, until the matter is finally resolved, that the record or set of records is accurate and pay its own *money* into a relevant account.

Notification requirements

7.6.16 R A *firm* must inform the *FSA* in writing without delay:

(1) if it has not complied with, or is unable, in any material respect, to comply with the requirements in ■ CASS 7.6.1 R, ■ CASS 7.6.2 R or ■ CASS 7.6.9 R;

(2) if having carried out a reconciliation it has not complied with, or is unable, in any material respect, to comply with ■ CASS 7.6.13 R to ■ CASS 7.6.15 R.

Audit of compliance with the MiFID client money rules

7.6.17 G *Firms* are reminded that the auditor of the *firm* has to confirm in the report submitted to the *FSA* under ■ SUP 3.10 (Duties of auditors: notification and report on client assets) that the *firm* has maintained systems adequate to enable it to comply with the *client money rules*.

7.6.18 G *Firms* that do not adopt the normal approach are reminded that the *firm's* auditor must confirm to the *FSA* in writing that the *firm* has in place systems and controls which are adequate to enable it to operate the alternative approach effectively (see ■ CASS 7.4.15 R).

7.6.19 G *Firms* that do not use the *standard method of internal client money reconciliation* are reminded that the *firm's* auditor must confirm to the *FSA* in writing that the *firm* has in place systems and controls which are adequate to enable it to use another method effectively (see ■ CASS 7.6.8 R).

7.7 Statutory trust

7.7.1 G Section 139(1) of the Act (Miscellaneous ancillary matters) provides that *rules* may make provision which result in *client money* being held by a *firm* on trust (England and Wales and Northern Ireland) or as agent (Scotland only). This section creates a fiduciary relationship between the *firm* and its *client* under which *client money* is in the legal ownership of the *firm* but remains in the beneficial ownership of the *client*. In the event of *failure* of the *firm*, costs relating to the distribution of *client money* may have to be borne by the trust.

Requirement

7.7.2 R A *firm* receives and holds *client money* as trustee (or in Scotland as agent) on the following terms:

(1) for the purposes of and on the terms of the *client money rules* and the *client money (MiFID business) distribution rules*;

(2) subject to (3), for the *clients* (other than *clients* which are *insurance undertakings* when acting as such with respect of *client money* received in the course of *insurance mediation activity* and that was opted in to this chapter) for whom that *money* is held, according to their respective interests in it;

(3) after all valid claims in (2) have been met, for *clients* which are *insurance undertakings* with respect of *client money* received in the course of *insurance mediation activity* according to their respective interests in it;

(4) on *failure* of the *firm*, for the payment of the costs properly attributable to the distribution of the *client money* in accordance with (2); and

(5) after all valid claims and costs under (2) to (4) have been met, for the *firm* itself.

7.8 Notification and acknowledgement of trust

Banks

7.8.1 R (1) When a *firm* opens a *client bank account*, the *firm* must give or have given written notice to the bank requesting the bank to acknowledge to it in writing that:

(a) all *money* standing to the credit of the account is held by the *firm* as trustee (or if relevant, as agent) and that the bank is not entitled to combine the account with any other account or to exercise any right of set-off or counterclaim against *money* in that account in respect of any sum owed to it on any other account of the *firm*; and

(b) the title of the account sufficiently distinguishes that account from any account containing *money* that belongs to the *firm*, and is in the form requested by the *firm*.

(2) In the case of a *client bank account* in the *United Kingdom*, if the bank does not provide the required acknowledgement within 20 *business days* after the *firm* dispatched the notice, the *firm* must withdraw all *money* standing to the credit of the account and *deposit* it in a *client bank account* with another bank as soon as possible.

Exchange, clearing house, intermediate broker or OTC counterparty

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 *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* or counterparty and arrange as soon as possible for the transfer or liquidation of any open positions and the repayment of any *money*.

7.9 Client money distribution

Application

7.9.1 R This section (the *client money (MiFID business) distribution rules*) applies to a *firm* that holds *client money* which is subject to the *client money rules* when a *primary pooling event* or a *secondary pooling event* occurs.

Purpose

7.9.2 G The *client money (MiFID business) distribution rules* seek to facilitate the timely return of *client money* to a *client* in the event of the *failure* of a *firm* or third party at which the *firm* holds *client money*.

Failure of the authorised firm: primary pooling event

7.9.3 G A *firm* can hold *client money* in either a *general client bank account*, a *designated client bank account* or a *designated client fund account*. A *firm* holds all *client money* in *general client bank accounts* for its *clients* as part of a common pool of *money* so those particular *clients* do not have a claim against a specific sum in a specific account; they only have a claim to the *client money* in general. A *firm* holds *client money* in *designated client bank accounts* or *designated client fund accounts* for those *clients* that requested their *client money* be part of a specific pool of *money*, so those particular *clients* do have a claim against a specific sum in a specific account; they do not have a claim to the *client money* in general unless a *primary pooling event* occurs. A *primary pooling event* triggers a notional pooling of all the *client money*, in every type of *client money* account, and the obligation to distribute it. If the *firm* becomes insolvent, and there is (for whatever reason) a *shortfall* in *money* held for a *client* compared with that *client*'s entitlements, the available funds will be distributed in accordance with the *client money (MiFID business) distribution rules*.

7.9.4 R A *primary pooling event* occurs:

(1) on the *failure* of the *firm*;

(2) on the vesting of assets in a *trustee* in accordance with an 'assets *requirement*' imposed under section 48(1)(b) of the *Act*;

(3) on the coming into force of a *requirement* for all *client money* held by the *firm*; or

(4) when the *firm* notifies, or is in breach of its duty to notify, the *FSA*, in accordance with CASS 7.6.16 R (Notification requirements), that it is unable correctly to identify and allocate in its records all valid claims arising as a result of a *secondary pooling event*.

7.9.5 R CASS 7.9.4 R (4) does not apply so long as:

(1) the *firm* is taking steps, in consultation with the *FSA*, to establish those records; and

(2) there are reasonable grounds to conclude that the records will be capable of rectification within a reasonable period.

Pooling and distribution

7.9.6 R If a *primary pooling event* occurs:

(1) *client money* held in each *client money* account of the *firm* is treated as pooled; and

(2) the *firm* must distribute that *client money* in accordance with CASS 7.7.2 R, so that each *client* receives a sum which is rateable to the *client money* entitlement calculated in accordance with CASS 7.9.7 R.

7.9.7 R (1) When, in respect of a *client*, there is a positive individual *client* balance and a negative *client equity balance*, the credit must be offset against the debit reducing the individual *client* balance for that *client*.

(2) When, in respect of a *client*, there is a negative individual *client* balance and a positive *client equity balance*, the credit must be offset against the debit reducing *client equity balance* for that *client*.

7.9.8 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*.

Client money received after the failure of the firm

7.9.9 R *Client money* received by the *firm* after a *primary pooling event* must not be pooled with *client money* held in any *client money* account operated by the *firm* at the time of the *primary pooling event*. It must be placed in a *client bank account* that has been opened after that event and must be handled in accordance with the *client money rules*, and returned to the relevant *client* without delay, except to the extent that:

(1) it is *client money* relating to a transaction that has not settled at the time of the *primary pooling event*; or

(2) it is *client money* relating to a *client*, for whom the *client money* entitlement, calculated in accordance with ■ CASS 7.9.7 R, shows that *money* is due from the *client* to the *firm* at the time of the *primary pooling event*.

7.9.10 G *Client money* received after the *primary pooling event* relating to an unsettled transaction should be used to settle that transaction. Examples of such transactions include:

(1) an equity transaction with a trade date before the date of the *primary pooling event* and a settlement date after the date of the *primary pooling event*; or

(2) a *contingent liability investment* that is 'open' at the time of the *primary pooling event* and is due to settle after the *primary pooling event*.

7.9.11 R If a *firm* receives a *mixed remittance* after a *primary pooling event*, it must:

(1) pay the full sum into the separate *client bank account* opened in accordance with ■ CASS 7.9.9 R; and

(2) pay the *money* that is not *client money* out of that *client bank account* into a *firm's* own bank account within one *business day* of the *day* on which the *firm* would normally expect the remittance to be cleared.

7.9.12 G Whenever possible the *firm* should seek to split a *mixed remittance* before the relevant accounts are credited.

Failure of a bank, intermediate broker, settlement agent or OTC counterparty: secondary pooling events

7.9.13 R If both a *primary pooling event* and a *secondary pooling event* occur, the provisions of this section relating to a *primary pooling event* apply.

7.9.14 R A *secondary pooling event* occurs on the *failure* of a third party to which *client money* held by the *firm* has been transferred under ■ CASS 7.4.1 R (1) to ■ CASS 7.4.1 R (3) (Depositing client money) or ■ CASS 7.5.2 R (Transfer of client money to a third party).

7.9.15 R ■ CASS 7.9.19 R to ■ CASS 7.9.31 R do not apply if, on the *failure* of the third party, the *firm* repays to its *clients* or pays into a *client bank account*, at an unaffected bank, an amount equal to the amount of *client money* which would have been held if a *shortfall* had not occurred at that third party.

7.9.16 G When *client money* is transferred to a third party, a *firm* continues to owe fiduciary duties to the *client*. Whether a *firm* is liable for a *shortfall* in *client money* caused by a third party failure will depend on whether it has complied with its duty of care as agent or trustee.

Failure of a bank

7.9.17 G When a bank *fails* and the *firm* decides not to make good the *shortfall* in the amount of *client money* held at that bank, a *secondary pooling event* will occur in accordance with ■ CASS 7.9.19 R. The *firm* would be expected to reflect the *shortfall* that arises at the *failed* bank in its records of the entitlement of *clients* and of *money* held with third parties.

7.9.18 G The *client money (MiFID business) distribution rules* seek to ensure that *clients* who have previously specified that they are not willing to accept the risk of the bank that has *failed*, and who therefore requested that their *client money* be placed in a *designated client bank account* at a different bank, should not suffer the loss of the bank that has *failed*.

Failure of a bank: pooling

7.9.19 R If a *secondary pooling event* occurs as a result of the *failure* of a bank where one or more *general client bank accounts* are held, then:

(1) in relation to every *general client bank account* of the *firm*, the provisions of ■ CASS 7.9.21 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply;

(2) in relation to every *designated client bank account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7.9.23 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply;

(3) in relation to each *designated client fund account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7.9.24 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply;

(4) any *money* held at a bank, other than the bank that has *failed*, in *designated client bank accounts*, is not pooled with any other *client money*; and

(5) any *money* held in a *designated client fund account*, no part of which is held by the bank that has *failed*, is not pooled with any other *client money*.

7.9.20 R If a *secondary pooling event* occurs as a result of the *failure* of a bank where one or more *designated client bank accounts* or *designated client fund accounts* are held, then:

(1) in relation to every *designated client bank account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7.9.23 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply; and

(2) in relation to each *designated client fund account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7.9.24 R, ■ CASS 7.9.26 R and ■ CASS 7.9.27 R will apply.

7.9.21 R *Money* held in each *general client bank account* and *client transaction account* of the *firm* must be treated as pooled and:

(1) any *shortfall* in *client money* held, or which should have been held, in *general client bank accounts* and *client transaction accounts*, that has arisen as a result of the *failure* of the bank, must be borne by all the *clients* whose *client money* is held in either a *general client bank account* or *client transaction account* of the *firm*, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each *client* by the *firm*, to reflect the requirements in (1), and the *firm's* records must be amended to reflect the reduced *client money* entitlement;

(3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the *failed* bank until the *client* is repaid; and

(4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to ■ CASS 7.6.2 R (Records and accounts), ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance) (as described in ■ CASS 7.6.6 G).

7.9.22 G The term 'which should have been held' is a reference to the *failed* bank's *failure* to hold the *client money* at the time of the pooling event.

7.9.23 R For each *client* with a *designated client bank account* held at the *failed* bank:

(1) any *shortfall* in *client money* held, or which should have been held, in *designated client bank accounts* that has arisen as a result of the *failure*, must be borne by all the *clients* whose *client money* is held in a *designated client bank account* of the *firm* at the *failed* bank, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each of the relevant *clients* by the *firm*, and the *firm's* records must be amended to reflect the reduced *client money* entitlement;

(3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the *failed* bank until the *client* is repaid; and

(4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to ■ CASS 7.6.2 R (Records and accounts), ■ SYSC 4.1.1

R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance) (as described in ■ CASS 7.6.6 G).

7.9.24 R *Money* held in each *designated client fund account* with the *failed bank* must be treated as pooled with any other *designated client fund accounts* of the *firm* which contain part of the same designated fund and:

(1) any *shortfall* in *client money* held, or which should have been held, in *designated client fund accounts* that has arisen as a result of the *failure*, must be borne by each of the *clients* whose *client money* is held in that designated fund, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each *client* by the *firm*, in accordance with (1), and the *firm*'s records must be amended to reflect the reduced *client money* entitlement;

(3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the *failed* bank until the *client* is repaid; and

(4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to ■ CASS 7.6.2 R (Records and accounts), ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance) (as described in ■ CASS 7.6.6 G).

7.9.25 R A *client* whose *money* was held, or which should have been held, in a *designated client bank account* with a bank that has *failed* is not entitled to claim in respect of that *money* against any other *client bank account* or *client transaction account* of the *firm*.

Client money received after the failure of a bank

7.9.26 R *Client money* received by the *firm* after the *failure* of a bank, that would otherwise have been paid into a *client bank account* at that bank:

(1) must not be transferred to the *failed* bank unless specifically instructed by the *client* in order to settle an obligation of that *client* to the *failed* bank; and

(2) must be, subject to (1), placed in a separate *client bank account* that has been opened after the *secondary pooling event* and either:

(a) on the written instruction of the *client*, transferred to a bank other than the one that has *failed*; or

(b) returned to the *client* as soon as possible.

7.9.27 R If a *firm* receives a *mixed remittance* after the *secondary pooling event* which consists of *client money* that would have been paid into a *general client bank account*, a *designated client bank account* or a *designated client fund account* maintained at the bank that has *failed*, it must:

(1) pay the full sum into a *client bank account* other than one operated at the bank that has *failed*; and

(2) pay the *money* that is not *client money* out of that *client bank account* within one *business day* of the day on which the *firm* would normally expect the remittance to be cleared.

7.9.28 G Whenever possible the *firm* should seek to split a *mixed remittance* before the relevant accounts are credited.

Failure of an intermediate broker, settlement agent or OTC counterparty: Pooling

7.9.29 R If a *secondary pooling event* occurs as a result of the *failure* of an *intermediate broker, settlement agent* or *OTC* counterparty, then in relation to every *general client bank account* and *client transaction account* of the *firm*, the provisions of ■ CASS 7.9.30 R and ■ CASS 7.9.31 R will apply.

7.9.30 R *Money* held in each *general client bank account* and *client transaction account* of the *firm* must be treated as pooled and:

(1) any *shortfall* in *client money* held, or which should have been held, in *general client bank accounts* and *client transaction account*, that has arisen as a result of the *failure*, must be borne by all the *clients* whose *client money* is held in either a *general client bank account* or a *client transaction accounts* of the *firm*, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each *client* by the *firm*, to reflect the requirements of (1), and the *firm's* records must be amended to reflect the reduced *client money* entitlement;

(3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the *failed intermediate broker, settlement agent* or *OTC* counterparty until the *client* is repaid; and

(4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to ■ CASS 7.6.2 R (Records and accounts), ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance) (as described in ■ CASS 7.6.6 G).

Client money received after the failure of an intermediate broker, settlement agent or OTC counterparty

7.9.31 R *Client money* received by the *firm* after the *failure* of an *intermediate broker*, *settlement agent* or OTC counterparty, that would otherwise have been paid into a *client transaction account* at that *intermediate broker*, *settlement agent* or OTC counterparty:

(1) must not be transferred to the *failed* third party unless specifically instructed by the *client* in order to settle an obligation of that *client* to the *failed intermediate broker*, *settlement agent* or OTC counterparty; and

(2) must be, subject to (1), placed in a separate *client bank account* that has been opened after the *secondary pooling event* and either:

(a) on the written instruction of the *client*, transferred to a third party other than the one that has *failed*; or

(b) returned to the *client* as soon as possible.

Notification to the FSA: failure of a bank, intermediate broker, settlement agent or OTC counterparty

7.9.32 R On the *failure* of a third party with which *money* is held, a *firm* must notify the *FSA*:

(1) as soon as it becomes aware of the *failure* of any bank, *intermediate broker*, *settlement agent*, OTC counterparty or other entity with which it has placed, or to which it has passed, *client money*; and

(2) as soon as reasonably practical, whether it intends to make good any *shortfall* that has arisen or may arise and of the amounts involved.

Annex 1

As explained in CASS 7.6.6 G, in complying with its obligations under CASS 7.6.2 R (Records and accounts), SYSC 4.1.1 G (General organisational requirements) and SYSC 6.1.1 R (Compliance), a *firm* should carry out internal reconciliations of records and accounts of *client money* the *firm* holds in *client bank accounts* and *client transaction accounts*. This Annex sets out a method of reconciliation that the *FSA* believes is appropriate for these purposes (the *standard method of internal client money reconciliation*).

1. Each *business day*, a *firm* that adopts the normal approach (see CASS 7.4.17 G) should check whether its *client money* resource, being the aggregate balance on the *firm's client bank accounts*, as at the close of business on the previous *business day*, was at least equal to the *client money* requirement, as defined in paragraph 6 below, as at the close of business on that day.

2. Each *business day*, a *firm* that adopts the alternative approach (see CASS 7.4.18 G) should ensure that its *client money* resource, being the aggregate balance on the *firm's client bank accounts*, as at the close of business on that *business day* is at least equal to the *client money* requirement, as defined in paragraph 6 below, as at the close of business on the previous *business day*.

3. No excess or *shortfall* should arise when adopting the alternative approach.

4. If a *firm* is operating the alternative approach and draws a cheque on its own bank account, it will be expected to account for those cheques that have not yet cleared when performing its reconciliations of records and accounts under paragraph 2. An historic average estimate of uncleared cheques may be used to satisfy this obligation (see CASS 7.4.19 G (3)).

5. For the purposes of performing its reconciliations of records and accounts under paragraphs 1 or 2, a *firm* should use the values contained in its accounting records, for example its cash book, rather than values contained in statements received from its banks and other third parties.

Client money requirement

6. The *client money* requirement is either:

(1) (subject to paragraph 18) the sum of, for all *clients*:

(a) the individual *client* balances calculated in accordance with paragraph 7, excluding:

(i) individual *client* balances which are negative (that is, debtors); and

(ii) *clients' equity balances*; and

(b) the total *margined transaction* requirement calculated in accordance with paragraph 14; or

(2) the sum of:

(a) for each *client bank account*:

(i) the amount which the *firm's* records show as held on that account; and

(ii) an amount that offsets each negative net amount which the *firm's* records show attributed to that account for an individual *client*; and

(b) the total *margined transaction* requirement calculated in accordance with paragraph 14.

General transactions

The individual *client* balance for each *client* should be calculated in accordance with this table:

Individual client balance calculation	
Free *money* (no trades) and	A
sale proceeds due to the *client*:	
(a) in respect of *principal deals* when the *client* has delivered the *designated investments*; and	B
(b) in respect of agency *deals*, when either	
(i) the sale proceeds have been received by the *firm* and the *client* has delivered the *designated investments*; or	C1
(ii) the *firm* holds the *designated investments* for the *client*; and	C2
the cost of purchases:	
(c) in respect of *principal deals* paid for by the *client* but the *firm* has not delivered the *designated investments* to the client; and	D
(d) in respect of agency *deals* paid for by the *client* when either	
(i) the *firm* has not remitted the *money* to, or to the order of, the counterparty; or	E1
(ii) the *designated investments* have been received by the *firm* but have not been delivered to the *client*;	E2
Less	
money owed by the *client* in respect of unpaid purchases by or for the *client* if delivery of those *designated investments* has been made to the *client*; and	F
Proceeds remitted to the *client* in respect of sales transactions by or for the *client* if the *client* has not delivered the *designated investments*	G
Individual *Client* Balance 'X' = (A+B+C1+C2+D+E1+E2)-F-G	X

8. A *firm* should calculate the individual *client* balance using the contract value of any *client* purchases or sales.

9. A *firm* may choose to segregate *designated investments* instead of the value identified in paragraph 7 (except E1) if it ensures that the *designated investments* are held in such a manner that the *firm* cannot use them for its own purposes.

10. Segregation in the context of paragraph 9 can take many forms, including the holding of a *safe custody investment* in a nominee name and the safekeeping of certificates evidencing title in a fire resistant safe. It is not the intention that all the *custody rules* in the *MiFID custody chapter* should be applied to *designated investments* held in the course of settlement.

11. In determining the *client money* requirement under paragraph 6, a *firm* need not include *money* held in accordance with CASS 7.2.8 R (Delivery versus payment transaction).

12. In determining the *client money* requirement under paragraph 6, a *firm*:

(1) should include dividends received and interest earned and allocated;

(2) may deduct outstanding *fees*, calls, rights and interest charges and other amounts owed by the *client* which are due and payable to the *firm* (see CASS 7.2.9 R);

(3) need not include *client money* in the form of *client* entitlements which are not required to be segregated (see CASS 7.4.27 G) nor include *client money* forwarded to the *firm* by its appointed representatives, *tied agents*, field representatives and other agents, but not received (see CASS 7.4.24 G);

(4) should take into account any *client money* arising from CASS 7.6.13 R (Reconciliation discrepancies); and

(5) should include any unallocated *client money*.

Equity balance

13. A *firm's* equity balance, whether with an exchange, *intermediate broker* or *OTC* counterparty, is the amount which the *firm* would be liable to pay to the exchange, *intermediate broker* or *OTC* counterparty (or vice-versa) in respect of the *firm's margined transactions* if each of the open positions of the *firm's clients* was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and the *firm's* account with the exchange, *intermediate broker* or *OTC* counterparty is closed.

Margined transaction requirement

14. The total *margined transaction* requirement is:

(1) the sum of each of the *client's equity balances* which are positive;

Less

(2) the proportion of any individual negative *client equity balance* which is secured by *approved collateral*; and

(3) the net aggregate of the *firm's* equity balance (negative balances being deducted from positive balances) on transaction accounts for *customers* with exchanges, *clearing houses*, *intermediate brokers* and *OTC* counterparties.

15. To meet a shortfall that has arisen in respect of the requirement in paragraph 6(1)(b) or 6(2)(b), a *firm* may utilise its own *approved collateral* provided it is held on terms specifying when it is to be realised for the benefit of *clients*, it is clearly identifiable from the *firm's* own property and the relevant terms are evidenced in writing by the *firm*. In addition, the proceeds of the sale of that *collateral* should be paid into a *client bank account*.

16. If a *firm's* total *margined transaction* requirement is negative, the *firm* should treat it as zero for the purposes of calculating its *client money* requirement.

17. The terms '*client equity balance*' and '*firm's* equity balance' in paragraph 13 refer to cash values and do not include non-cash *collateral* or other *designated investments* held in respect of a *margined transaction*.

17A. A *firm* with a *Part 30 exemption order* which also operates an LME bond arrangement for the benefit of US-resident investors, should exclude the *client equity balances* for transactions undertaken on the London Metal Exchange on behalf of those US-resident investors from the calculation of the *margined transaction* requirement.

Reduced client money requirement option

18.

(1) When, in respect of a *client*, there is a positive individual *client* balance and a negative *client equity balance*, a *firm* may offset the credit against the debit and hence have a reduced individual *client* balance in paragraph 7 for that *client*.

(2) When, in respect of a *client*, there is a negative individual *client* balance and a positive *client equity balance*, a firm may offset the credit against the debit and hence have a reduced *client equity balance* in paragraph 14 for that *client*.

19. The effect of paragraph 18 is to allow a *firm* to offset, on a *client* by *client* basis, a negative amount with a positive amount arising out of the calculations in paragraphs 7 and 14, and, by so doing, reduce the amount the *firm* is required to segregate.

Chapter 7

Client money rules

7.1 Application and Purpose

Application

7.1.1 R This chapter (the *client money rules*) applies to a *firm* that receives *money* from or holds *money* for, or on behalf of, a *client* in the course of, or in connection with:

(1) [deleted]

(a) [deleted]

(b) [deleted]

(2) [deleted]

(3) its *MiFID business*; and/or

(4) its *designated investment business*, that is not *MiFID business* in respect of any *investment agreement* entered into, or to be entered into, with or for a *client*;

unless otherwise specified in this section.

7.1.2 G [deleted]

Opt-in to the client money rules

7.1.3 R (1) A *firm* that receives or holds *money* to which this chapter applies in relation to:

(a) its *MiFID business*; or

(b) its *MiFID business* and its *designated investment business* which is not *MiFID business*;

and holds *money* in respect of which CASS 5 applies, may elect to comply with the provisions of this chapter in respect of all such *money* and if it does so, this chapter applies as if all such *money* were *money* that the *firm* receives and holds in the course of, or in connection with, its *MiFID business*.

(1A) [deleted]

(1B) A *firm* that receives or holds *money* to which this chapter applies solely in relation to its *designated investment business* which is not *MiFID business* and receives or holds *money* in respect of which the *insurance client money chapter* applies, may elect to comply with the provisions of this chapter in respect of all such *money* and if it does so, this chapter applies as if all such *money* were *money* that the *firm* receives and holds in the course of or in connection with its *designated investment business*.

(2) A *firm* must make and retain a written record of any election it makes under this *rule*, including the date from which the election is to be effective. The *firm* must make the record on the date it makes the election and must keep it for a period of five years after ceasing to use it.

7.1.4 G The opt-in to the *client money rules* inthis chapter does not apply in respect of *money* that a *firm* holds outside of the scope of the *insurance client money chapter*.

7.1.5 G If a *firm* has opted to comply with this chapter, the *insurance client money chapter* will have no application to the activities to which the election applies.

7.1.6 G A *firm* that is only subject to the *insurance client money chapter* may not opt to comply with this chapter.

7.1.7 G [deleted]

7.1.7A G [deleted]

Professional client opt-out

7.1.7B R ■ CASS 7.1.7C G to ■ CASS 7.1.7I G do not apply to a *firm* in relation to *money* held in connection with its *MiFID business* to which this chapter applies or in relation to *money* for which the *firm* has made an election under ■ CASS 7.1.3 R (1).

Money that is not client money: 'opt outs' for any business other than *insurance mediation activity*

7.1.7C G The 'opt out' provisions provide a *firm* with the option of allowing a *professional client* to choose whether their *money* is subject to the *client money rules* (unless the *firm* is conducting *insurance mediation activity*).

PAGE 3

7.1.7D R Subject to ■ CASS 7.1.7F R, *money* is not *client money* when a *firm* (other than a *sole trader*) holds that *money* on behalf of, or receives it from, a *professional client*, other than in the course of *insurance mediation activity*,

and the *firm* has obtained written acknowledgement from the *professional client* that:

(1) *money* will not be subject to the protections conferred by the *client money rules*;

(2) as a consequence, this *money* will not be segregated from the *money* of the *firm* in accordance with the *client money rules* and will be used by the *firm* in the course of its own business; and

(3) the *professional client* will rank only as a general creditor of the *firm*.

'Opt-outs' for non-IMD business

7.1.7E G For a *firm* whose business is not governed by the *Insurance Mediation Directive*, it is possible to 'opt out' on a one-way basis. However, in order to maintain a comparable regime to that applying to *MiFID business*, all '*MiFID* type' business undertaken outside the scope of *MiFID*, should comply with the *client money rules* or be 'opted out' on a two-way basis.

7.1.7F R *Money* is not *client money* if a *firm*, in respect of *designated investment business* which is not an *investment service or activity*, an *ancillary service*, a *listed activity* or *insurance mediation activity*:

(1) holds it on behalf of or receives it from a *professional client* who is not an *authorised person*; and

(2) has sent a separate written notice to the *professional client* stating the matters set out in CASS 7.1.7DR (1) to CASS 7.1.7DR (3).

7.1.7G G When a *firm* undertakes a range of business for a *professional client* and has separate agreements for each type of business undertaken, the *firm* may treat *client money* held on behalf of the *client* differently for different types of business; for example, a *firm* may, under CASS 7.1.7D R or CASS 7.1.7F R, elect to segregate *client money* in connection with *securities* transactions and not segregate (by complying with CASS 7.1.7D R or CASS 7.1.7F R) *money* in connection with *contingent liability investments* for the same *client*.

7.1.7H R When a *firm* transfers *client money* to another *person*, the *firm* must not enter into an agreement under CASS 7.1.7D R or CASS 7.1.7F R with that other *person* in relation to that *client money* or represent to that other *person* that the *money* is not *client money*.

7.1.7I G CASS 7.1.7H R prevents a *firm*, when passing *client money* to another *person* under CASS 7.5.2 R (transfer of client money to a third party), from making use of the 'opt out' provisions under CASS 7.1.7D R or CASS 7.1.7F R.

Credit institutions and approved banks

7.1.8 R The *client money rules* do not apply to a *BCD credit institution* in relation to deposits within the meaning of the *BCD* held by that *institution*.

[Note: article 13(8) of *MiFID* and article 18(1) of the *MiFID implementing Directive*]

7.1.9 G If a *credit institution* that holds *money* as a deposit with itself is subject to the *requirement to disclose information before providing services*, it should, in compliance with that obligation, notify the *client* that:

(1) *money* held for that *client* in an account with the *credit institution* will be held by the *firm* as banker and not as trustee (or in Scotland as agent); and

(2) as a result, the *money* will not be held in accordance with the *client money rules*.

7.1.10 G Pursuant to *Principle* 10 (Clients' assets), a *credit institution* that holds *money* as a deposit with itself should be able to account to all of its *clients* for amounts held on their behalf at all times. A bank account opened with the *firm* that is in the name of the *client* would generally be sufficient. When *money* from *clients* deposited with the *firm* is held in a pooled account, this account should be clearly identified as an account for *clients*. The *firm* should also be able to demonstrate that an amount owed to a specific *client* that is held within the pool can be reconciled with a record showing that individual's *client* balance and is, therefore, identifiable at any time. Similarly, where that *money* is reflected only in a *firm's* bank account with other banks (nostro accounts), the *firm* should be able to reconcile amounts owed to that *client* within a reasonable period of time.

7.1.11 G A *credit institution* is reminded that the exemption for deposits is not an absolute exemption from the *client money rules*.

7.1.11A R (1) This *rule* applies to a *firm* which is an *approved bank* but not a *BCD credit institution*.

(2) The *client money rules* do not apply to money held by the *approved bank* if it is undertaking business which is not *MiFID business* but only when the money is held in an account with itself, in which case the *firm* must notify the *client* in writing that:

(a) *money* held for that *client* in an account with the *approved bank* will be held by the *firm* as banker and not as trustee (or in Scotland as agent); and

(b) as a result, the *money* will not be held in accordance with the *client money rules*.

PAGE 5

Affiliated companies - MiFID business

7.1.12 G A *firm* that holds *money* on behalf of, or receives *money* from, an *affiliated company* in respect of *MiFID business* must treat the *affiliated company* as any other *client* of the *firm* for the purposes of this chapter.

Affiliated companies - non-MiFID business

7.1.12A R A *firm* that holds *money* on behalf of, or receives *money* from, an *affiliated company* in respect of *designated investment business* which is not *MiFID business* must not treat the *money* as *client money* unless:

(1) the *firm* has been notified by the *affiliated company* that the *money* belongs to a *client* of the *affiliated company*; or

(2) the *affiliated company* is a *client* dealt with at arm's length; or

(3) the *affiliated company* is a manager of an *occupational pension scheme* or is an overseas company; and

(a) the *money* is given to the *firm* in order to carry on *designated investment business* for or on behalf of the *clients* of the *affiliated company*; and

(b) the *firm* has been notified by the *affiliated company* that the *money* is to be treated as *client money*.

7.1.13 G [deleted]

7

Coins

7.1.14 R The *client money rules* do not apply with respect to coins held on behalf of a *client* if the *firm* and the *client* have agreed that the *money* (or *money* of that type) is to be held by the *firm* for the intrinsic value of the metal which constitutes the coin.

Solicitors

7.1.15 R (1) An *authorised professional firm* regulated by the Law Society (of England and Wales), the Law Society of Scotland or the Law Society of Northern Ireland must comply with the following rules of its *designated professional body* and, where relevant paragraph (3), and if it does so, it will be deemed to comply with the *client money rules*.

(2) The relevant rules are:

(a) if the *firm* is regulated by the Law Society (of England and Wales):

(i) the Solicitors' Accounts Rules 1998; or

(ii) where applicable, the Solicitors Overseas Practice Rules 1990;

(b) if the *firm* is regulated by the Law Society of Scotland, the Solicitors' (Scotland) Accounts, Accounts Certificate, Professional Practice and Guarantee Fund Rules 2001; and

(c) if the *firm* is regulated by the Law Society of Northern Ireland, the Solicitors' Accounts Regulations 1998.

(3) If the *firm* in (1) is a *MiFID investment firm* that receives or holds *money* for, or on behalf of a client in the course of, or in connection with its *MiFID business*, it must also comply with the *MiFID client money (minimum implementing) rules* in relation to that business.

Long term insurers and friendly societies

7.1.15A R This chapter does not apply to the *permitted activities* of a *long-term insurer* or a *friendly society*, unless it is a *MiFID investment firm* that receives *money* from or holds *money* for or on behalf of a *client* in the course of, or in connection with, its *MiFID business*.

Contracts of insurance

7.1.15B R This chapter does not apply to *client money* held by a *firm* which:

(1) receives or holds *client money* in relation to *contracts of insurance*; but which

(2) in relation to such *client money* elects to act in accordance with the *insurance client money chapter*.

7.1.15C R A *firm* should make and retain a written record of any election which it makes under ■ CASS 7.1.15B R.

Life assurance business

7.1.15D G (1) A *firm* which receives and holds *client money* in respect of life assurance business in the course of its *designated investment business* that is not *MiFID business* may:

(a) under ■ CASS 7.1.3 R (1B) elect to comply with the *client money chapter* in respect of such *client money* and in doing so avoid the need to comply with the *insurance client money chapter* which would otherwise apply to the *firm* in respect of *client money* received in the course of its *insurance mediation activity*; or

(b) under ■ CASS 7.1.15B R, elect to comply with the *insurance client money chapter* in respect of such *client money*.

(2) These options are available to a *firm* irrespective of whether it also receives and holds *client money* in respect of other parts of its *designated investment business*. A *firm* may not however choose to comply with the *insurance client money chapter* in respect of *client money* which it receives and holds in the course of any part of its *designated investment business* which does not involve an *insurance mediation activity*.

PAGE 7

Trustee firms (other than trustees of unit trust schemes)

7.1.15E R A *trustee firm* which holds *money* in relation to its *designated investment business* which is not *MiFID business* to which this chapter applies, must hold any such *client money* separate from its own *money* at all times.

7.1.15F R Only the *client money rules* listed in the table below apply to a *trustee firm* in connection with *money* that the firm receives, or holds for or on behalf of a client in the course of or in connection with its *designated investment business* which is not *MiFID business*.

Reference	Rule
CASS 7.1.1 R to CASS 7.1.6 G, and CASS 7.1.8 R to CASS 7.1.14 R	Application
CASS 7.1.15E R and CASS 7.1.15F R	Trustee firms (other than trustees of unit trust schemes)
CASS 7.1.16 G	General principle
CASS 7.7.2 R to CASS 7.7.4 G	Requirement
CASS 7.4.1 R to CASS 7.4.6 G	Depositing client money
CASS 7.4.7 R to CASS 7.4.13 G	A firm's selection of credit institution, bank or money market fund
CASS 7.6.6 G to CASS 7.6.16 R	Reconciliation of client money balances

General purpose

7.1.16 G (1) *Principle* 10 (Clients' assets) requires a *firm* to arrange adequate protection for *clients'* assets when the *firm* is responsible for them. An essential part of that protection is the proper accounting and treatment of *client money*. The *client money rules* provide requirements for *firms* that receive or hold *client money*, in whatever form.

(2) The *client money rules* also where relevantimplement the provisions of *MiFID* which regulate the obligations of a *firm* when it holds *client money* in the course of its *MiFID business*.

7.2 Definition of client money

7.2.1 R [deleted]

7.2.2 R [deleted]

Title transfer collateral arrangements

7.2.3 R 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, such *money* should no longer be regarded as *client money*.

[Note: recital 27 to *MiFID*]

7.2.4 G A title transfer financial collateral arrangement under the *Financial Collateral Directive* is an example of a type of transfer of *money* to cover obligations where that *money* will not be regarded as *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 a security interest over 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 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 to the *firm*.

7.2.6 G *Firms* are reminded of the *client's best interest rule*, which requires a *firm* to act honestly, fairly and professionally in accordance with the best interests of its *clients* when structuring its business particularly in respect of the effect of that structure on *firms'* obligations under the *client money rules*.

Dis 9 7.2.7 G Pursuant to the *client's best interests rule*, a *firm* should ensure that where a *retail client* transfers full ownership of *money* to a *firm*:

(1) the *client* is notified that full ownership of the *money* has been transferred to the *firm* and, as such, the *client* no longer has a proprietary claim over this *money* and the *firm* can deal with it on its own right;

(2) the transfer is for the purposes of securing or covering the *client's* obligations;

(3) an equivalent transfer is made back to the *client* if the provision of collateral by the *client* is no longer necessary; and

(4) there is a reasonable link between the timing and the amount of the collateral transfer and the obligation that the *client* owes, or is likely to owe, to the *firm*.

Money in connection with a "delivery versus payment" transaction

7.2.8 R *Money* need not be treated as *client money* in respect of a delivery versus payment transaction through a commercial settlement system if it is intended that either:

(1) in respect of a *client's* purchase, *money* from a *client* will be due to the *firm* within one *business day* upon the fulfilment of a delivery obligation; or

(2) in respect of a *client's* sale, *money* is due to the *client* within one *business day* following the *client's* fulfilment of a delivery obligation;

unless the delivery or payment by the *firm* does not occur by the close of business on the third *business day* following the date of payment or delivery of the *investments* by the *client*.

7.2.8A G The exclusion from the *client money rules* for delivery versus payment transactions under CASS 7.2.8 R is an example of an exclusion from the *client money rules* which is permissible by virtue of recital 26 of *MiFID*.

7.2.8B R *Money* need not be treated as *client money* in respect of a delivery versus payment transaction, for the purpose of settling a transaction in relation to *units* in a *regulated collective investment scheme*, if:

(1) the *authorised fund manager* receives it from a *client* in relation to the *authorised fund manager's* obligation to issue *units*, in an *AUT* or to arrange for the issue of *units* in an *ICVC*, in accordance with *COLL*, unless the *price* of those *units* has not been determined by the close of business on the next *business day*:

(a) following the date of the receipt of the *money* from the *client*; or

(b) if the *money* was received by an *appointed representative* of the *authorised fund manager*, in accordance with CASS 7.4.24 G, following the date of receipt at the specified business address of the *authorised fund manager*; or

(2) the *money* is held in the course of redeeming *units* where the proceeds of that redemption are paid to a *client* within the time specified in *COLL*; when an *authorised fund manager* draws a cheque or other payable order within these time frames the provisions of ■ CASS 7.2.17 R and ■ CASS 7.2.9 R (2) will not apply.

Money due and payable to the firm

7.2.9 R

(1) *Money* is not *client money* when it becomes properly due and payable to the *firm* for its own account.

(2) For these purposes, if a *firm* makes a payment to, or on the instructions of, a *client*, from an account other than a *client bank account*, until that payment has cleared, no equivalent sum from a client bank account for reimbursement will become due and payable to the *firm*.

7.2.10 G *Money* held as *client money* becomes due and payable to the *firm* or for the *firm's* own account, for example, because the *firm* acted as *principal* in the contract or the *firm*, acting as agent, has itself paid for *securities* in advance of receiving the purchase *money* from its *client*. The circumstances in which it is due and payable will depend on the contractual arrangement between the *firm* and the *client*.

7.2.11 G When a *client's* obligation or liability, that is secured by that *client's* asset, crystallises, and the *firm* realises the asset in accordance with an agreement entered into between the *client* and the *firm*, the part of the proceeds of the asset to cover such liability that is due and payable to the *firm* is not *client* money. However, any proceeds of sale in excess of the amount owed by the *client* to the *firm* should be paid over to the *client* immediately or be held in accordance with the *client money rules*.

Commission rebate

7.2.12 G When a *firm* has entered into an arrangement under which *commission* is rebated to a *client*, those rebates need not be treated as *client money* until they become due and payable to the *client* in accordance with the terms of the contractual arrangements between the parties.

7.2.13 G When *commission* rebate becomes due and payable to the *client*, the *firm* should:

(1) treat it as *client money*; or

(2) pay it out in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (see ■ CASS 7.2.15 R);

unless the *firm* and the *client* have entered into an arrangement under which the *client* has agreed to transfer full ownership of this *money* to the *firm* as collateral against payment of future professional fees (see ■ CASS 7.2.3 R (Title transfer collateral arrangements)).

PAGE 14

Interest

7.2.14 R Unless a *firm* notifies a *retail client* in writing whether or not interest is to be paid on *client money* and, if so, on what terms and at what frequency,

it must pay that *client* all interest earned on that *client money*. Any interest due to a *client* will be *client money*.

Discharge of fiduciary duty

7.2.15 R *Money* ceases to be *client money* if it is paid:

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

(2) 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 7.5.2 R (Transfer of client money to a third party); or

(3) 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 CASS 7.2.9 R (Money due and payable to the firm)); or

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

7.2.16 G When a *firm* wishes to transfer *client money* balances to a third party in the course of transferring its business to another *firm*, it should do so in a way which it discharges its fiduciary duty to the *client* under this section.

7.2.17 R When a *firm* draws a cheque or other payable order to discharge its fiduciary duty to the *client*, it must continue to treat the sum concerned as *client money* until the cheque or order is presented and paid by the bank.

Allocated but unclaimed client money

7.2.18 G The purpose of the *rule* on allocated but unclaimed *client money* is to allow a *firm*, in the normal course of its business, to cease to treat as *client money* any balances, allocated to an individual *client*, when those balances remain unclaimed.

7.2.19 R A *firm* may cease to treat as *client money* any unclaimed *client money* balance if it can demonstrate that it has taken reasonable steps to trace the *client* concerned and to return the balance.

7.2.20 (1) Reasonable steps should include:

(a) entering into a written agreement, in which the *client* consents to the *firm* releasing, after the period of time specified in (b), any *client money* balances, for or on behalf of that *client*, from *client bank accounts*;

(b) determining that there has been no movement on the *client's* balance for a period of at least six years (notwithstanding any payments or receipts of charges, interest or similar items);

(c) writing to the *client* at the last known address informing the *client* of the *firm's* intention of no longer treating that balance as *client money*, giving the *client* 28 days to make a claim;

(d) making and retaining records of all balances released from *client bank accounts*; and

(e) undertaking to make good any valid claim against any released balances.

(2) Compliance with (1) may be relied on as tending to establish compliance with ■ CASS 7.2.19 R.

(3) Contravention of (1) may be relied on as tending to establish contravention of ■ CASS 7.2.19 R.

7.2.21 G When a *firm* gives an undertaking to make good any valid claim against released balances, it should make arrangements authorised by the *firm's* relevant *controllers* that are legally enforceable by any *person* with a valid claim to such *money*.

7.3 Organisational requirements: client money

Requirement to protect client money

7.3.1 R A *firm* must, when holding *client money*, make adequate arrangements to safeguard the *client's* rights and prevent the use of *client money* for its own account.

[Note: article 13(8) of *MiFID*]

Requirement to have adequate organisational arrangements

7.3.2 R A *firm* must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of *client money*, or of rights in connection with *client money*, as a result of misuse of *client money*, fraud, poor administration, inadequate record-keeping or negligence.

[Note: article 16(1)(f) of the *MiFID implementing Directive*]

7.4 Segregation of client money

Depositing client money

7.4.1 R A *firm*, on receiving any *client money*, must promptly place this *money* into one or more accounts opened with any of the following:

(1) a central bank;

(2) a *BCD credit institution*;

(3) a bank authorised in a third country;

(4) a *qualifying money market fund*.

[Note: article 18(1) of the *MiFID implementing Directive*]

7.4.2 G An account with a central bank, a *BCD credit institution* or a bank authorised in a third country in which *client money* is placed is a *client bank account*.

Qualifying money market funds

7.4.3 G Where a *firm* deposits *client money* with a *qualifying money market fund*, the units in that fund should be held in accordance with CASS 6.

[Note: recital 23 to the *MiFID implementing Directive*]

7.4.4 G A *firm* that places *client money* in a *qualifying money market fund* should ensure that it has the *permissions* required to invest in and hold units in that fund and must comply with the *rules* that are relevant for those activities.

7.4.5 R A *firm* must give a *client* the right to oppose the placement of his *money* in a *qualifying money market fund*.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.6 G If a *firm* that intends to place *client money* in a *qualifying money market fund* is subject to the *requirement to disclose information before providing services*, it should, in compliance with that obligation, notify the *client* that:

(1) *money* held for that *client* will be held in a *qualifying money market fund*; and

(2) as a result, the *money* will not be held in accordance with the *client money rules* but in accordance with the *custody rules*.

A firm's selection of a credit institution, bank or money market fund

7.4.7 R A *firm* that does not deposit *client money* with a central bank must exercise all due skill, care and diligence in the selection, appointment and periodic review of the *credit institution*, bank or *qualifying money market fund* where the *money* is deposited and the arrangements for the holding of this *money*.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.8 R When a *firm* makes the selection, appointment and conducts the periodic review of a *credit institution*, a bank or a *qualifying money market fund*, it must take into account:

(1) the expertise and market reputation of the third party; and

(2) any legal requirements or market practices related to the holding of *client money* that could adversely affect *clients*' rights.

[Note: article 18(3) of the *MiFID implementing Directive*]

7.4.9 G In discharging its obligations when selecting, appointing and reviewing the appointment of a *credit institution*, a bank or a *qualifying money market fund*, a *firm* should also consider, together with any other relevant matters:

(1) the need for diversification of risks;

(2) the capital of the *credit institution* or bank;

(3) the amount of *client money* placed, as a proportion of the *credit institution* or bank's capital and *deposits*, and, in the case of a *qualifying money market fund*, compared to any limit the fund may place on the volume of redemptions in any period;

(4) the credit rating of the *credit institution* or bank; and

(5) to the extent that the information is available, the level of risk in the investment and loan activities undertaken by the *credit institution* or bank and *affiliated companies*.

7.4.10 R A *firm* must make a record of the grounds upon which it satisfies itself as to the appropriateness of its selection of a *credit institution*, a bank or a *qualifying money market fund*. The *firm* must make the record on the date it makes the selection and must keep it from the date of such selection until five years after the *firm* ceases to use the third party to hold *client money*.

Client bank accounts

7.4.11 R A *firm* must take the necessary steps to ensure that *client money* deposited, in accordance with CASS 7.4.1 R, in a central bank, a *credit institution*, a bank authorised in a third country or a *qualifying money market fund* is held in an account or accounts identified separately from any accounts used to hold *money* belonging to the *firm*.

[Note: article 16(1)(e) of the *MiFID implementing Directive*]

7.4.12 G A *firm* may open one or more *client bank accounts* in the form of a *general client bank account*, a *designated client bank account* or a *designated client fund account* (see CASS 7.9.3 G).

7.4.13 G A *designated client fund account* may be used for a *client* only where that *client* has consented to the use of that account and all other *designated client fund accounts* which may be pooled with it. For example, a *client* who consents to the use of bank A and bank B should have his *money* held in a different *designated client fund account* at bank B from a *client* who has consented to the use of banks B and C.

Payment of client money into a client bank account

7.4.14 G Two approaches that a *firm* can adopt in discharging its obligations under the *client money segregation requirements* are:

(1) the 'normal approach'; or

(2) the 'alternative approach'.

7.4.15 R A *firm* that does not adopt the normal approach must first send a written confirmation to the *FSA* from the *firm's* auditor that the *firm* has in place systems and controls which are adequate to enable it to operate another approach effectively.

7.4.16 G The alternative approach would be appropriate for a *firm* that operates in a multi-product, multi-currency environment for which adopting the normal approach would be unduly burdensome and would not achieve the *client* protection objective. Under the alternative approach, *client money* is received into and paid out of a *firm's* own bank accounts; consequently the *firm* should have systems and controls that are capable of monitoring the *client money* flows so that the *firm* comply with its obligations to perform reconciliations of records and accounts (see CASS 7.6.2 R). A *firm* that adopts the alternative approach will segregate *client money* into a *client bank account* on a daily basis, after having performed a reconciliation of records and accounts of the entitlement of each *client* for whom the *firm* holds *client money* with the records and accounts of the *client money* the *firm* holds in *client bank account* and *client transaction accounts* to determine what the *client money* requirement was at the close of the previous *business day*.

PAGE 17

7.4.17 G Under the normal approach, a *firm* that receives *client money* should either:

(1) pay it promptly, and in any event no later than the next *business day* after receipt, into a *client bank account*; or

(2) pay it out in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (see CASS 7.2.15 R).

7.4.18 G Under the alternative approach, a *firm* that receives *client money* should:

(1) (a) pay any *money* to or on behalf of *clients* out of its own account; and

(b) perform a reconciliation of records and accounts required under CASS 7.6.2 R (Records and accounts), and where relevant SYSC 4.1.1 R and SYSC 6.1.1 R, adjust the balance held in its *client bank accounts* and then segregate the *money* in the *client bank account* until the calculation is re-performed on the next *business day*; or

(2) pay it out in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (see CASS 7.2.15 R).

7.4.19 G A *firm* that adopts the alternative approach may:

(1) receive all *client money* into its own bank account;

(2) choose to operate the alternative approach for some types of business (for example, overseas equities transactions) and operate the normal approach for other types of business (for example, *contingent liability investments*) if the *firm* can demonstrate that its systems and controls are adequate (see CASS 7.4.15 R); and

(3) use an historic average to account for uncleared cheques (see paragraph 4 of CASS 7 Annex 1 G).

7.4.20 G Pursuant to the *client money segregation requirements*, a *firm* should ensure that any *money* other than *client money* deposited in a *client bank account* is promptly paid out of that account unless it is a minimum sum required to open the account, or to keep it open.

7.4.21 R If it is prudent to do so to ensure that *client money* is protected, a *firm* may pay into a *client bank account money* of its own, and that *money* will then become *client money* for the purposes of this chapter.

Automated transfers

7.4.22 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach that receives *client money* in the form of an automated transfer should take reasonable steps to ensure that:

(1) the *money* is received directly into a *client bank account*; and

(2) if *money* is received directly into the *firm's* own account, the *money* is transferred into a *client bank account* promptly, and in any event, no later than the next *business day* after receipt.

Mixed remittance

7.4.23 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach that receives a *mixed remittance* (that is part *client money* and part other *money*) should:

(1) pay the full sum into a *client bank account* promptly, and in any event, no later than the next *business day* after receipt; and

(2) pay the *money* that is not *client money* out of the *client bank account* promptly, and in any event, no later than one *business day* of the day on which the *firm* would normally expect the remittance to be cleared.

Appointed representatives, tied agents, field representatives and other agents

7.4.24 G (1) Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach should establish and maintain procedures to ensure that *client money* received by its *appointed representatives*, *tied agents*, *field representatives* or other agents is:

(a) paid into a *client bank account* of the *firm* promptly, and in any event, no later than the next *business day* after receipt; or

(b) forwarded to the *firm*, or in the case of a *field representative* forwarded to a specified business address of the *firm*, so as to ensure that the *money* arrives at the specified business address promptly, and in any event, no later than the close of the third *business day*.

(2) For the purposes of 1(b), *client money* received on *business day* one should be forwarded to the *firm* or specified business address of the *firm* promptly, and in any event, no later than the next *business day* after receipt (*business day* two) in order for it to reach that *firm* or specified business address by the close of the third *business day*. Procedures requiring the *client money* in the form of a cheque to be sent to the *firm* or the specified business address of the *firm* by first class post promptly, and in any event, no later than the next *business day* after receipt, would be in line with 1(b).

7.4.25 G The *firm* should ensure that its *appointed representatives*, *tied agents*, *field representatives* or other agents keep *client money* separately identifiable from any other *money* (including that of the *firm*) until the *client money* is paid into a *client bank account* or sent to the *firm*.

7.4.26 G A *firm* that operates a number of small branches, but holds or accounts for all *client money* centrally, may treat those small branches in the same way as *appointed representatives* and *tied agents*.

Client entitlements

7.4.27 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach that receives outside the *United Kingdom* a *client* entitlement on behalf of a *client* should pay any part of it which is *client money*:

(1) to, or in accordance with, the instructions of the *client* concerned; or

(2) into a *client bank account* promptly, and in any event, no later than five *business days* after the *firm* is notified of its receipt.

7.4.28 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach should allocate a *client* entitlement that is *client money* to the individual *client* promptly and, in any case, no later than ten *business days* after notification of receipt.

Money due to a client from a firm

7.4.29 G Pursuant to the *client money segregation requirements*, a *firm* operating the normal approach that is liable to pay *money* to a *client* should promptly, and in any event no later than one *business day* after the *money* is due and payable, pay the *money*:

(1) to, or to the order of, the *client*; or

(2) into a *client bank account*.

Segregation in different currency

7.4.30 R A *firm* may segregate *client money* in a different currency from that of receipt. If it does so, the *firm* must ensure that the amount held is adjusted each *day* to an amount at least equal to the original currency amount (or the currency in which the *firm* has its liability to its *clients*, if different), translated at the previous day's closing spot exchange rate.

7.4.31 G The *rule* on segregation of *client money* in a different currency (■ CASS 7.4.30 R) does not apply where the *client* has instructed the *firm* to convert the *money* into and hold it in a different currency.

Commodity Futures Trading Commission Part 30 exemption order

7.4.32 G United States (US) legislation restricts the ability of non-US firms to trade on behalf of US customers on non-US futures and options exchanges. The relevant US regulator (the *CFTC*) operates an exemption system for *firms* authorised by the *FSA*. The *FSA* sponsors the application from a *firm* for exemption from Part 30 of the General Regulations under the US Commodity Exchange Act in line with this system. The application forms and associated information can be found on the *FSA* website in the "Forms" section.

7.4.33 G A *firm* with a *Part 30 exemption order* undertakes to the *CFTC* that it will refuse to allow any US customer to opt not to have his *money* treated as *client money* if it is held or received in respect of transactions on non-US exchanges, unless that US customer is an "eligible contract participant" as defined in section 1a(12) of the Commodity Exchange Act, 7 U.S.C. In doing so, the *firm* is representing that if available to it, it will not make use of the opt-out arrangements in ■ CASS 7.1.7B R to ■ CASS 7.1.7F R in relation to that business.

7.4.34 R A *firm* must not reduce the amount of, or cancel a letter of credit issued under, an LME bond arrangement where this will cause the *firm* to be in breach of its *Part 30 exemption order*.

7.4.35 R A *firm* must notify the *FSA* immediately it arranges the *issue* of an individual letter of *credit* under an LME bond arrangement.

7.5 Transfer of client money to a third party

7.5.1 G This section sets out the requirements a *firm* must comply with when it transfers *client money* to another *person* without discharging its fiduciary duty owed to that *client*. Such circumstances arise when, for example, a *firm* passes *client money* to a *clearing house* in the form of margin for the *firm's* obligations to the *clearing house* that are referable to transactions undertaken by the *firm* for the relevant clients. They may also arise when a *firm* passes *client money* to an *intermediate broker* for *contingent liability investments* in the form of initial or variation margin on behalf of a *client*. In these circumstances, the *firm* remains responsible for that *client's equity balance* held at the *intermediate broker* until the contract is terminated and all of that *client's* positions at that *broker* closed. If a *firm* wishes to discharge itself from its fiduciary duty, it should do so in accordance with the *rule* regarding the discharge of a *firm's* fiduciary duty to the *client* (■ CASS 7.2.15 R).

7.5.2 R A *firm* may allow another *person*, such as an exchange, a *clearing house* or an *intermediate broker*, to hold or control *client money*, but only if:

(1) the *firm* transfers the *client money*:

(a) for the purpose of a transaction for a *client* through or with that *person*; or

(b) to meet a *client's* obligation to provide collateral for a transaction (for example, an *initial margin* requirement for a *contingent liability investment*); and

(2) in the case of a *retail client*, that *client* has been notified that the *client money* may be transferred to the other *person*.

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*.

7.6 Records, accounts and reconciliations

Records and accounts

7.6.1 R A *firm* must keep such records and accounts as are necessary to enable it, at any time and without delay, to distinguish *client money* held for one *client* from *client money* held for any other *client*, and from its own *money*.

[Note: article 16(1)(a) of the *MiFID implementing Directive*]

7.6.2 R A *firm* must maintain its records and accounts in a way that ensures their accuracy, and in particular their correspondence to the *client money* held for *clients*.

[Note: article 16(1)(b) of the *MiFID implementing Directive*]

Client entitlements

7.6.3 G Pursuant to CASS 7.6.2 R, and where relevant SYSC 4.1.1 R and SYSC 6.1.1 R, a *firm* should take reasonable steps to ensure that is notified promptly of any receipt of *client money* in the form of a *client* entitlement.

Record keeping

7.6.4 R A *firm* must ensure that records made under CASS 7.6.1 R and CASS 7.6.2 R are retained for a period of five years after they were made.

7.6.5 G A *firm* should ensure that it makes proper records, sufficient to show and explain the *firm's* transactions and commitments in respect of its *client money*.

Internal reconciliations of client money balances

7.6.6 G (1) Carrying out internal reconciliations of records and accounts of the entitlement of each *client* for whom the *firm* holds *client money* with the records and accounts of the *client money* the *firm* holds in *client bank accounts* and *client transaction accounts* should be one of the steps a *firm* takes to satisfy its obligations under CASS 7.6.2 R, and where relevant SYSC 4.1.1 R and SYSC 6.1.1 R.

(2) A *firm* should perform such internal reconciliations:

(a) as often as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of the *firm's* records and accounts.

(3) The *standard method of internal client money reconciliation* sets out a method of reconciliation of client money balances that the *FSA* believes should be one of the steps that a *firm* takes when carrying out internal reconciliations of *client money*.

Records

7.6.7 R (1) A *firm* must make records, sufficient to show and explain the method of internal reconciliation of *client money* balances under ■ CASS 7.6.2 R used, and if different from the *standard method of internal client money reconciliation*, to show and explain that:

(a) the method of internal reconciliation of *client money* balances used affords an equivalent degree of protection to the *firm's clients* to that afforded by the *standard method of internal client money reconciliation*; and

(b) in the event of a *primary pooling event* or a *secondary pooling event*, the method used is adequate to enable the *firm* to comply with the *client money distribution rules*.

(2) A *firm* must make these records on the date it starts using a method of internal reconciliation of *client money* balances and must keep it made for a period of five years after ceasing to use it.

7.6.8 R A *firm* that does not use the *standard method of internal client money reconciliation* must first send a written confirmation to the *FSA* from the *firm's* auditor that the *firm* has in place systems and controls which are adequate to enable it to use another method effectively.

Reconciliations with external records

7.6.9 R A *firm* must conduct, on a regular basis, reconciliations between its internal accounts and records and those of any third parties by whom *client money* is held.

[Note: article 16(1)(c) of the *MiFID implementing Directive*]

Frequency of external reconciliations

7.6.10 G (1) A *firm* should perform the required reconciliation of *client money* balances with external records:

(a) as regularly as is necessary; and

(b) as soon as reasonably practicable after the date to which the reconciliation relates;

to ensure the accuracy of its internal accounts and records against those of third parties by whom *client money* is held.

(2) In determining whether the frequency is adequate, the *firm* should consider the risks which the business is exposed, such as the nature, volume and complexity of the business, and where and with whom the *client money* is held.

Method of external reconciliations

7.6.11 G A method of reconciliation of *client money* balances with external records that the *FSA* believes is adequate is when a *firm* compares:

(1) the balance on each *client bank account* as recorded by the *firm* with the balance on that account as set out on the statement or other form of confirmation issued by the bank with which those accounts are held; and

(2) the balance, currency by currency, on each *client transaction account* as recorded by the *firm*, with the balance on that account as set out in the statement or other form of confirmation issued by the *person* with whom the account is held;

and identifies any discrepancies between them.

7.6.12 R Any *approved collateral* held in accordance with the *client money rules* must be included within this reconciliation.

Reconciliation discrepancies

7.6.13 R When any discrepancy arises as a result of a *firm's* internal reconciliations, the *firm* must identify the reason for the discrepancy and ensure that:

(1) any *shortfall* is paid into a *client bank account* by the close of business on the day that the reconciliation is performed; or

(2) any excess is withdrawn within the same time period (but see ■ CASS 7.4.20 G and ■ CASS 7.4.21 R).

7.6.14 R When any discrepancy arises as a result of the reconciliation between a *firm's* internal records and those of third parties that hold *client money*, the *firm* must identify the reason for the discrepancy and correct it as soon as possible, unless the discrepancy arises solely as a result of timing differences between the accounting systems of the party providing the statement or confirmation and that of the *firm*.

7.6.15 R While a *firm* is unable to resolve a difference arising from a reconciliation between a *firm's* internal records and those of third parties that hold *client money*, and one record or a set of records examined by the *firm* during its reconciliation indicates that there is a need to have a greater amount of *client money* or *approved collateral* than is in fact the case, the *firm* must assume, until the matter is finally resolved, that the record or set of records is accurate and pay its own *money* into a relevant account.

Notification requirements

7.6.16 R A *firm* must inform the *FSA* in writing without delay:

(1) if it has not complied with, or is unable, in any material respect, to comply with the requirements in ■ CASS 7.6.1 R, ■ CASS 7.6.2 R or ■ CASS 7.6.9 R;

(2) if having carried out a reconciliation it has not complied with, or is unable, in any material respect, to comply with ■ CASS 7.6.13 R to ■ CASS 7.6.15 R.

Audit of compliance with the MiFID client money rules

7.6.17 G *Firms* are reminded that the auditor of the *firm* has to confirm in the report submitted to the *FSA* under ■ SUP 3.10 (Duties of auditors: notification and report on client assets) that the *firm* has maintained systems adequate to enable it to comply with the *client money rules*.

7.6.18 G *Firms* that do not adopt the normal approach are reminded that the *firm's* auditor must confirm to the *FSA* in writing that the *firm* has in place systems and controls which are adequate to enable it to operate the alternative approach effectively (see ■ CASS 7.4.15 R).

7.6.19 G *Firms* that do not use the *standard method of internal client money reconciliation* are reminded that the *firm's* auditor must confirm to the *FSA* in writing that the *firm* has in place systems and controls which are adequate to enable it to use another method effectively (see ■ CASS 7.6.8 R).

7.7 Statutory trust

7.7.1 G Section 139(1) of the Act (Miscellaneous ancillary matters) provides that *rules* may make provision which result in *client money* being held by a *firm* on trust (England and Wales and Northern Ireland) or as agent (Scotland only). This section creates a fiduciary relationship between the *firm* and its *client* under which *client money* is in the legal ownership of the *firm* but remains in the beneficial ownership of the *client*. In the event of *failure* of the *firm*, costs relating to the distribution of *client money* may have to be borne by the trust.

Requirement

7.7.2 R A *firm* receives and holds *client money* as trustee (or in Scotland as agent) on the following terms:

(1) for the purposes of and on the terms of the *client money rules* and the *client money distribution rules*;

(2) subject to (3), for the *clients* (other than *clients* which are *insurance undertakings* when acting as such with respect of *client money* received in the course of *insurance mediation activity* and that was opted in to this chapter) for whom that *money* is held, according to their respective interests in it;

(3) after all valid claims in (2) have been met, for *clients* which are *insurance undertakings* with respect of *client money* received in the course of *insurance mediation activity* according to their respective interests in it;

(4) on *failure* of the *firm*, for the payment of the costs properly attributable to the distribution of the *client money* in accordance with (2); and

(5) after all valid claims and costs under (2) to (4) have been met, for the *firm* itself.

PAGE 27

7.7.3 R A *trustee firm* which is subject to the *client money rules* by virtue of ■ CASS 7.1.1 R (4):

(1) must receive and hold *client money* in accordance with the relevant instrument of trust;

(2) subject to that, receives and holds *client money* on trust on the terms (or in Scotland on the agency terms) specified in ■ CASS 7.7.2 R.

7.7.4 G If a *trustee firm* holds *client money* in accordance with ■ CASS 7.7.3 R (2), the *firm* should follow the provisions in ■ CASS 7.1.15E R and ■ CASS 7.1.15F R.

7.8 Notification and acknowledgement of trust

Banks

7.8.1 R

(1) When a *firm* opens a *client bank account*, the *firm* must give or have given written notice to the bank requesting the bank to acknowledge to it in writing that:

(a) all *money* standing to the credit of the account is held by the *firm* as trustee (or if relevant, as agent) and that the bank is not entitled to combine the account with any other account or to exercise any right of set-off or counterclaim against *money* in that account in respect of any sum owed to it on any other account of the *firm*; and

(b) the title of the account sufficiently distinguishes that account from any account containing *money* that belongs to the *firm*, and is in the form requested by the *firm*.

(2) In the case of a *client bank account* in the *United Kingdom*, if the bank does not provide the required acknowledgement within 20 *business days* after the *firm* dispatched the notice, the *firm* must withdraw all *money* standing to the credit of the account and *deposit* it in a *client bank account* with another bank as soon as possible.

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* or counterparty and arrange as soon as possible for the transfer or liquidation of any open positions and the repayment of any *money*.

7.9 [Deleted]

Annex 1

As explained in CASS 7.6.6 G, in complying with its obligations under CASS 7.6.2 R (Records and accounts), and where relevant SYSC 4.1.1 R (General organisational requirements) and SYSC 6.1.1 R (Compliance), a *firm* should carry out internal reconciliations of records and accounts of *client money* the *firm* holds in *client bank accounts* and *client transaction accounts*. This Annex sets out a method of reconciliation that the *FSA* believes is appropriate for these purposes (the *standard method of internal client money reconciliation*).

1. Each *business day*, a *firm* that adopts the normal approach (see CASS 7.4.17 G) should check whether its *client money* resource, being the aggregate balance on the *firm's client bank accounts*, as at the close of business on the previous *business day*, was at least equal to the *client money* requirement, as defined in paragraph 6 below, as at the close of business on that day.

2. Each *business day*, a *firm* that adopts the alternative approach (see CASS 7.4.18 G) should ensure that its *client money* resource, being the aggregate balance on the *firm's client bank accounts*, as at the close of business on that *business day* is at least equal to the *client money* requirement, as defined in paragraph 6 below, as at the close of business on the previous *business day*.

3. No excess or *shortfall* should arise when adopting the alternative approach.

4. If a *firm* is operating the alternative approach and draws a cheque on its own bank account, it will be expected to account for those cheques that have not yet cleared when performing its reconciliations of records and accounts under paragraph 2. An historic average estimate of uncleared cheques may be used to satisfy this obligation (see CASS 7.4.19 G (3)).

5. For the purposes of performing its reconciliations of records and accounts under paragraphs 1 or 2, a *firm* should use the values contained in its accounting records, for example its cash book, rather than values contained in statements received from its banks and other third parties.

Client money requirement

6. The *client money* requirement is either:

(1) (subject to paragraph 18) the sum of, for all *clients*:

(a) the individual *client* balances calculated in accordance with paragraph 7, excluding:

(i) individual *client* balances which are negative (that is, debtors); and

(ii) *clients' equity balances*; and

(b) the total *margined transaction* requirement calculated in accordance with paragraph 14; or

(2) the sum of:

(a) for each *client bank account*:

(i) the amount which the *firm's* records show as held on that account; and

(ii) an amount that offsets each negative net amount which the *firm's* records show attributed to that account for an individual *client*; and

(b) the total *margined transaction* requirement calculated in accordance with paragraph 14.

General transactions

The individual *client* balance for each *client* should be calculated in accordance with this table:

Individual client balance calculation	
Free *money* (no trades) and	A
sale proceeds due to the *client*:	
(a) in respect of *principal deals* when the *client* has delivered the *designated investments*; and	B
(b) in respect of agency *deals*, when either:	
(i) the sale proceeds have been received by the *firm* and the *client* has delivered the *designated investments*; or	C1
(ii) the *firm* holds the *designated investments* for the *client*; and	C2
the cost of purchases:	
(c) in respect of *principal deals*, paid for by the *client* but the *firm* has not delivered the *designated investments* to the client; and	D
(d) in respect of agency *deal*, paid for by the *client* when either:	
(i) the *firm* has not remitted the *money* to, or to the order of, the counterparty; or	E1
(ii) the *designated investments* have been received by the *firm* but have not been delivered to the *client*;	E2
Less	
money owed by the *client* in respect of unpaid purchases by or for the *client* if delivery of those *designated investments* has been made to the *client*; and	F
Proceeds remitted to the *client* in respect of sales transactions by or for the *client* if the *client* has not delivered the *designated investments*.	G
Individual *Client* Balance 'X' = (A+B+C1+C2+D+E1+E2)-F-G	X

8. A *firm* should calculate the individual *client* balance using the contract value of any *client* purchases or sales.

9. A *firm* may choose to segregate *designated investments* instead of the value identified in paragraph 7 (except E1) if it ensures that the *designated investments* are held in such a manner that the *firm* cannot use them for its own purposes.

10. Segregation in the context of paragraph 9 can take many forms, including the holding of a *safe custody investment* in a nominee name and the safekeeping of certificates evidencing title in a fire resistant safe. It is not the intention that all the *custody rules* in the *custody chapter* should be applied to *designated investments* held in the course of settlement.

11. In determining the *client money* requirement under paragraph 6, a *firm* need not include *money* held in accordance with ■ CASS 7.2.8 R (Delivery versus payment transaction).

12. In determining the *client money* requirement under paragraph 6, a *firm*:

(1) should include dividends received and interest earned and allocated;

(2) may deduct outstanding *fees*, calls, rights and interest charges and other amounts owed by the *client* which are due and payable to the *firm* (see ■ CASS 7.2.9 R);

(3) need not include *client money* in the form of *client* entitlements which are not required to be segregated (see CASS 7.4.27 G) nor include *client money* forwarded to the *firm* by its appointed representatives, *tied agents*, field representatives and other agents, but not received (see CASS 7.4.24 G);

(4) should take into account any *client money* arising from CASS 7.6.13 R (Reconciliation discrepancies); and

(5) should include any unallocated *client money*.

Equity balance

13. A *firm's* equity balance, whether with an exchange, *intermediate broker* or *OTC* counterparty, is the amount which the *firm* would be liable to pay to the exchange, *intermediate broker* or *OTC* counterparty (or vice-versa) in respect of the *firm's margined transactions* if each of the open positions of the *firm's clients* was liquidated at the closing or settlement prices published by the relevant exchange or other appropriate pricing source and the *firm's* account with the exchange, *intermediate broker* or *OTC* counterparty is closed.

Margined transaction requirement

14. The total *margined transaction* requirement is:

(1) the sum of each of the *client's equity balances* which are positive;

Less

(2) the proportion of any individual negative *client equity balance* which is secured by *approved collateral*; and

(3) the net aggregate of the *firm's* equity balance (negative balances being deducted from positive balances) on transaction accounts for *customers* with exchanges, *clearing houses*, *intermediate brokers* and *OTC* counterparties.

15. To meet a shortfall that has arisen in respect of the requirement in paragraph 6(1)(b) or 6(2)(b), a *firm* may utilise its own *approved collateral* provided it is held on terms specifying when it is to be realised for the benefit of *clients*, it is clearly identifiable from the *firm's* own property and the relevant terms are evidenced in writing by the *firm*. In addition, the proceeds of the sale of that *collateral* should be paid into a *client bank account*.

16. If a *firm's* total *margined transaction* requirement is negative, the *firm* should treat it as zero for the purposes of calculating its *client money* requirement.

17. The terms '*client equity balance*' and '*firm's* equity balance' in paragraph 13 refer to cash values and do not include non-cash *collateral* or other *designated investments* held in respect of a *margined transaction*.

17A. A *firm* with a *Part 30 exemption order* which also operates an LME bond arrangement for the benefit of US-resident investors, should exclude the *client equity balances* for transactions undertaken on the London Metal Exchange on behalf of those US-resident investors from the calculation of the *margined transaction* requirement.

Reduced client money requirement option

PAGE 3

18.

(1) When, in respect of a *client*, there is a positive individual *client* balance and a negative *client equity balance*, a *firm* may offset the credit against the debit and hence have a reduced individual *client* balance in paragraph 7 for that *client*.

(2) When, in respect of a *client*, there is a negative individual *client* balance and a positive *client equity balance*, a firm may offset the credit against the debit and hence have a reduced *client equity balance* in paragraph 14 for that *client*.

19. The effect of paragraph 18 is to allow a *firm* to offset, on a *client* by *client* basis, a negative amount with a positive amount arising out of the calculations in paragraphs 7 and 14, and, by so doing, reduce the amount the *firm* is required to segregate.

Chapter 7A

Client money distribution

7A

7A.1 Application and purpose

Application

7A.1.1 R This chapter (the *client money distribution rules*) applies to a *firm* that holds *client money* which is subject to the *client money rules* when a *primary pooling event* or a *secondary pooling event* occurs.

Purpose

7A.1.2 G The *client money distribution rules* seek to facilitate the timely return of *client money* to a *client* in the event of the *failure* of a *firm* or third party at which the *firm* holds *client money*.

7A.2 Primary pooling events

Failure of the authorised firm: primary pooling event

7A.2.1 G

(1) A *firm* can hold *client money* in a *general client bank account*, a *designated client bank account* or a *designated client fund account*.

(2) A *firm* holds all *client money* in *general client bank accounts* for its *clients* as part of a common pool of *money* so those particular *clients* do not have a claim against a specific sum in a specific account; they only have a claim to the *client money* in general.

(3) A *firm* holds *client money* in *designated client bank accounts* or *designated client fund accounts* for those *clients* that requested their *client money* be part of a specific pool of *money*, so those particular *clients* do have a claim against a specific sum in a specific account; they do not have a claim to the *client money* in general unless a *primary pooling event* occurs. A *primary pooling event* triggers a notional pooling of all the *client money*, in every type of *client money* account, and the obligation to distribute it.

(4) If the *firm* becomes insolvent, and there is (for whatever reason) a *shortfall* in *money* held for a *client* compared with that *client's* entitlements, the available funds will be distributed in accordance with the *client money distribution rules*.

7A.2.2 R

A *primary pooling event* occurs:

(1) on the *failure* of the *firm*;

(2) on the vesting of assets in a *trustee* in accordance with an 'assets *requirement*' imposed under section 48(1)(b) of the *Act*;

(3) on the coming into force of a *requirement* for all *client money* held by the *firm*; or

(4) when the *firm* notifies, or is in breach of its duty to notify, the *FSA*, in accordance with ■ CASS 7.6.16 R (Notification requirements), that it is unable correctly to identify and allocate in its records all valid claims arising as a result of a *secondary pooling event*.

7A

7A.2.3 R ■ CASS 7A.2.2R (4) does not apply so long as:

(1) the *firm* is taking steps, in consultation with the *FSA*, to establish those records; and

(2) there are reasonable grounds to conclude that the records will be capable of rectification within a reasonable period.

Pooling and distribution

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

(1) *client money* held in each *client money* account of the *firm* is treated as pooled; and

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

7A.2.5 R (1) When, in respect of a *client*, there is a positive individual *client* balance and a negative *client equity balance*, the credit must be offset against the debit reducing the individual *client* balance for that *client*.

(2) When, in respect of a *client*, there is a negative individual *client* balance and a positive *client equity balance*, the credit must be offset against the debit reducing *client equity balance* for that *client*.

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*.

Client money received after the failure of the firm

7A.2.7 R *Client money* received by the *firm* after a *primary pooling event* must not be pooled with *client money* held in any *client money* account operated by the *firm* at the time of the *primary pooling event*. It must be placed in a *client bank account* that has been opened after that event and must be handled in accordance with the *client money rules*, and returned to the relevant *client* without delay, except to the extent that:

(1) it is *client money* relating to a transaction that has not settled at the time of the *primary pooling event*; or

(2) it is *client money* relating to a *client*, for whom the *client money* entitlement, calculated in accordance with ■ CASS 7A.2.5 R, shows that *money* is due from the *client* to the *firm* at the time of the *primary pooling event*.

7A.2.8 G *Client money* received after the *primary pooling event* relating to an unsettled transaction should be used to settle that transaction. Examples of such transactions include:

(1) an equity transaction with a trade date before the date of the *primary pooling event* and a settlement date after the date of the *primary pooling event*; or

(2) a *contingent liability investment* that is 'open' at the time of the *primary pooling event* and is due to settle after the *primary pooling event*.

7A.2.9 R If a *firm* receives a *mixed remittance* after a *primary pooling event*, it must:

(1) pay the full sum into the separate *client bank account* opened in accordance with ■ CASS 7A.2.7 R; and

(2) pay the *money* that is not *client money* out of that *client bank account* into a *firm's* own bank account within one *business day* of the *day* on which the *firm* would normally expect the remittance to be cleared.

7A.2.10 G Whenever possible the *firm* should seek to split a *mixed remittance* before the relevant accounts are credited.

7A.2.11 R If both a *primary pooling event* and a *secondary pooling event* occur, the provisions of this section relating to a *primary pooling event* apply.

PAGE 5

7A

7A.3 Secondary pooling events

Failure of a bank, intermediate broker, settlement agent or OTC counterparty: secondary pooling events

7A.3.1 R A *secondary pooling event* occurs on the *failure* of a third party to which *client money* held by the *firm* has been transferred under ■ CASS 7.4.1 R (1) to ■ CASS 7.4.1 R (3) (Depositing client money) or ■ CASS 7.5.2 R (Transfer of client money to a third party).

7A.3.2 R ■ CASS 7A.3.6 R to ■ CASS 7A.3.18 R do not apply if, on the *failure* of the third party, the *firm* repays to its *clients* or pays into a *client bank account*, at an unaffected bank, an amount equal to the amount of *client money* which would have been held if a *shortfall* had not occurred at that third party.

7A.3.3 G When *client money* is transferred to a third party, a *firm* continues to owe fiduciary duties to the *client*. Whether a *firm* is liable for a *shortfall* in *client money* caused by a third party failure will depend on whether it has complied with its duty of care as agent or trustee.

Failure of a bank

7A.3.4 G When a bank *fails* and the *firm* decides not to make good the *shortfall* in the amount of *client money* held at that bank, a *secondary pooling event* will occur in accordance with ■ CASS 7A.3.6 R. The *firm* would be expected to reflect the *shortfall* that arises at the *failed* bank in its records of the entitlement of *clients* and of *money* held with third parties.

7A.3.5 G The *client money distribution rules* seek to ensure that *clients* who have previously specified that they are not willing to accept the risk of the bank that has *failed*, and who therefore requested that their *client money* be placed in a *designated client bank account* at a different bank, should not suffer the loss of the bank that has *failed*.

PAGE 6

Failure of a bank: pooling

7A.3.6 R If a *secondary pooling event* occurs as a result of the *failure* of a bank where one or more *general client bank accounts* are held, then:

(1) in relation to every *general client bank account* of the *firm*, the provisions of ■ CASS 7A.3.8 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply;

(2) in relation to every *designated client bank account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7A.3.10 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply;

(3) in relation to each *designated client fund account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7A.3.11 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply;

(4) any *money* held at a bank, other than the bank that has *failed*, in *designated client bank accounts*, is not pooled with any other *client money*; and

(5) any *money* held in a *designated client fund account*, no part of which is held by the bank that has *failed*, is not pooled with any other *client money*.

7A.3.7 R If a *secondary pooling event* occurs as a result of the *failure* of a bank where one or more *designated client bank accounts* or *designated client fund accounts* are held, then:

(1) in relation to every *designated client bank account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7A.3.10 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply; and

(2) in relation to each *designated client fund account* held by the *firm* with the *failed* bank, the provisions of ■ CASS 7A.3.11 R, ■ CASS 7A.3.13 R and ■ CASS 7A.3.14 R will apply.

7A.3.8 R *Money* held in each *general client bank account* and *client transaction account* of the *firm* must be treated as pooled and:

(1) any *shortfall* in *client money* held, or which should have been held, in *general client bank accounts* and *client transaction accounts*, that has arisen as a result of the *failure* of the bank, must be borne by all the *clients* whose *client money* is held in either a *general client bank account* or *client transaction account* of the *firm*, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each *client* by the *firm*, to reflect the requirements in (1), and the *firm*'s records must be amended to reflect the reduced *client money* entitlement;

(3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the *failed* bank until the *client* is repaid; and

(4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to ■ CASS 7.6.2 R (Records and accounts), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance).

7A.3.9 G The term "which should have been held" is a reference to the *failed* bank's *failure* to hold the *client money* at the time of the pooling event.

7A.3.10 R For each *client* with a *designated client bank account* held at the *failed* bank:

(1) any *shortfall* in *client money* held, or which should have been held, in *designated client bank accounts* that has arisen as a result of the *failure*, must be borne by all the *clients* whose *client money* is held in a *designated client bank account* of the *firm* at the *failed* bank, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each of the relevant *clients* by the *firm*, and the *firm's* records must be amended to reflect the reduced *client money* entitlement;

(3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the *failed* bank until the *client* is repaid; and

(4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to ■ CASS 7.6.2 R (Records and accounts), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance).

7A.3.11 R *Money* held in each *designated client fund account* with the *failed bank* must be treated as pooled with any other *designated client fund accounts* of the *firm* which contain part of the same designated fund and:

(1) any *shortfall* in *client money* held, or which should have been held, in *designated client fund accounts* that has arisen as a result of the *failure*, must be borne by each of the *clients* whose *client money* is held in that designated fund, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each *client* by the *firm*, in accordance with (1), and the *firm's* records must be amended to reflect the reduced *client money* entitlement;

(3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the *failed* bank until the *client* is repaid; and

(4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to ■ CASS 7.6.2 R (Records and accounts), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance).

7A.3.12 R A *client* whose *money* was held, or which should have been held, in a *designated client bank account* with a bank that has *failed* is not entitled to claim in respect of that *money* against any other *client bank account* or *client transaction account* of the *firm*.

Client money received after the failure of a bank

7A.3.13 R *Client money* received by the *firm* after the failure of a bank, that would otherwise have been paid into a *client bank account* at that bank:

(1) must not be transferred to the *failed* bank unless specifically instructed by the *client* in order to settle an obligation of that *client* to the *failed* bank; and

(2) must be, subject to (1), placed in a separate *client bank account* that has been opened after the *secondary pooling event* and either:

(a) on the written instruction of the *client*, transferred to a bank other than the one that has *failed*; or

(b) returned to the *client* as soon as possible.

7A.3.14 R If a *firm* receives a *mixed remittance* after the *secondary pooling event* which consists of *client money* that would have been paid into a *general client bank account*, a *designated client bank account* or a *designated client fund account* maintained at the bank that has *failed*, it must:

(1) pay the full sum into a *client bank account* other than one operated at the bank that has *failed*; and

(2) pay the *money* that is not *client money* out of that *client bank account* within one *business day* of the day on which the *firm* would normally expect the remittance to be cleared.

PAGE 9

7A.3.15 G Whenever possible the *firm* should seek to split a *mixed remittance* before the relevant accounts are credited.

7A

Failure of an intermediate broker, settlement agent or OTC counterparty: Pooling

7A.3.16 R If a *secondary pooling event* occurs as a result of the *failure* of an *intermediate broker*, *settlement agent* or *OTC* counterparty, then in relation to every *general client bank account* and *client transaction account* of the *firm*, the provisions of ■ CASS 7A.3.17 R and ■ CASS 7A.3.18 R will apply.

7A.3.17 R *Money* held in each *general client bank account* and *client transaction account* of the *firm* must be treated as pooled and:

(1) any *shortfall* in *client money* held, or which should have been held, in *general client bank accounts* and *client transaction accounts*, that has arisen as a result of the *failure*, must be borne by all the *clients* whose *client money* is held in either a *general client bank account* or a *client transaction account* of the *firm*, rateably in accordance with their entitlements;

(2) a new *client money* entitlement must be calculated for each *client* by the *firm*, to reflect the requirements of (1), and the *firm's* records must be amended to reflect the reduced *client money* entitlement;

(3) the *firm* must make and retain a record of each *client's* share of the *client money shortfall* at the *failed intermediate broker*, *settlement agent* or *OTC* counterparty until the *client* is repaid; and

(4) the *firm* must use the new *client money* entitlements, calculated in accordance with (2), for the purposes of reconciliations pursuant to ■ CASS 7.6.2 R (Records and accounts), and where relevant ■ SYSC 4.1.1 R (General organisational requirements) and ■ SYSC 6.1.1 R (Compliance).

Client money received after the failure of an intermediate broker, settlement agent or OTC counterparty

7A.3.18 R *Client money* received by the *firm* after the *failure* of an *intermediate broker*, *settlement agent* or *OTC* counterparty, that would otherwise have been paid into a *client transaction account* at that *intermediate broker*, *settlement agent* or *OTC* counterparty:

(1) must not be transferred to the *failed* third party unless specifically instructed by the *client* in order to settle an obligation of that *client* to the *failed intermediate broker*, *settlement agent* or *OTC* counterparty; and

(2) must be, subject to (1), placed in a separate *client bank account* that has been opened after the *secondary pooling event* and either:

(a) on the written instruction of the *client*, transferred to a third party other than the one that has *failed*; or

(b) returned to the *client* as soon as possible.

Notification to the FSA: failure of a bank, intermediate broker, settlement agent or OTC counterparty

7A.3.19 R On the *failure* of a third party with which *money* is held, a *firm* must notify the *FSA*:

(1) as soon as it becomes aware of the *failure* of any bank, *intermediate broker*, *settlement agent*, *OTC* counterparty or other entity with which it has placed, or to which it has passed, *client money*; and

(2) as soon as reasonably practical, whether it intends to make good any *shortfall* that has arisen or may arise and of the amounts involved.

LEHMAN BROTHERS

[redacted]

Dear [redacted]

Re: Money Market Deposits in the name of Lehman Brothers International (Europe), Client Segregated Account.

We refer to the above-captioned Money Market facility which is maintained in accordance with the Financial Services Authority's Client Asset's Rules ("FSA Rules"). We hereby notify and remind you that under such rules, client monies must be identified as such at all times. Through Reuters dealing system or telephone conversations, Lehman Brothers Holdings Inc (UK) Branch Treasury Dealers agree to place money with you on behalf of our clients, in the name of "Lehman Brothers International (Europe) Client Segregated Account" (hereinafter, "Client Segregated Account"). We hereby notify you that:

(a) all monies deposited in the Client Segregated Account are held by us a trustee, and you are not entitled to combine the Client Segregated Account with any other account or to exercise any right of set-off or counterclaim against money in the Client Segregated Account in respect of any sum owed you on any other account of Lehman Brothers International (Europe) or any of its affiliates ("Lehman").

(b) you must make the necessary provisions to record internally that any monies placed with you in the Client Segregated Account are 'client monies'.

The title of an account, such as the Client Segregated Account, in which client money is to be held, must sufficiently distinguish such account from any other account containing money that belongs to Lehman, and should be in the form in which we request from you.

Please return your signed acknowledgement of the above.

Yours sincerely,

[redacted]

Authorised Signatory

[redacted]

Authorised Signatory

Accepted by
Name of Bank:

Authorised Signatories:

Name(s) of Authorised Signatory:

Date:

Policy Statement

07/2

Financial Services Authority

Implementing the Markets in Financial Instruments Directive (MiFID)

Feedback on:

CP06/14 – Implementing MiFID for Firms and Markets (July 2006)

CP06/19 – Reforming Conduct of Business Regulation (October 2006)

CP06/20 – Financial promotion and other communications (October 2006)

January 2007

8 Client assets

Introduction

8.1 In Chapter 10 of CP06/14, we explained our proposals to implement the MiFID provisions for the safeguarding of client assets.

8.2 With a few exceptions noted below, respondents generally agreed with our proposals which broadly reflect the existing regulatory standard. Accordingly, we have decided to confirm our approach, with a few drafting changes that we discuss below.

8.3 A miscellaneous section addressing other significant issues, some of which will involve further work during the course of 2007, can be found at the end of this chapter. This section also features some new issues not originally set out in our Consultation Papers and information for solicitors that are MiFID firms.

Feedback and response to individual questions/comments

The opt-out for professionals

8.4 The loss of the professional opt-out is a significant change to the existing CASS regime. We consider that such an opt-out is incompatible with the MiFID segregation requirements and, accordingly, proposed in CP06/14 not to carry it forward into CASS 7. However, two Recitals to the Level 1 Directive[29] set out that certain monies and financial instruments do not fall within the definition of client money or of financial instruments belonging to clients. This will allow many existing arrangements to continue, but we note that the scope of the Recitals is not unlimited, and an unrestrained interpretation would be inconsistent with the spirit of the Directive.

Q5: Are there any current arrangements that might not be covered by the proposed carve-out under Recitals 26 and 27?

Q6: Would these arrangements have any unintended consequences that we would need to consider in our overall implementation of the Directive e.g. impact on repapering or firm permissions/requirements?

29 Recitals 26 and 27.

8.5 One respondent was concerned with the impact of the re-categorisation of intermediate customers as retail customers under MiFID. They noted that a restricted application of absolute title-transfer for retail clients as a whole is likely to have a significant impact on the way many firms finance and manage their business. In addition, respondents identified the possible need to change permissions and that repapering would be required.

Our response: Regarding the re-categorisation of intermediate customers as retails customers under MiFID, we expect that where clients are treated in a certain manner at present, the same result can be achieved under MiFID. This is also consistent with the assumption in our cost benefit analysis that the status quo continues and, accordingly, we do not intend to issue further guidance on this.

Whilst the same result may be achieved via the use of MiFID Recitals, we take this opportunity to reiterate our earlier comments that we would be concerned if firms tried to use the flexibility in the Recitals to avoid providing client money protection to retail clients. This would appear inconsistent with a firm's obligation to act honestly, fairly and professionally. Also, we would expect these arrangements to be properly documented between the firm and the client, and to involve good faith collateral or other arrangements, even where they relate to future or prospective obligations.

We appreciate that repapering will be required, but understand that firms will need to undertake such an exercise to implement other requirements under MiFID. We acknowledge that a firm may need to change its permission, but trust firms appreciate that this will be a necessary step in ensuring regulatory compliance.

Excess commission

8.6 We proposed in CP06/14 that firms receiving commission on behalf of clients in the course of MiFID activities would be able to hold excess commission outside the client money regime. We suggested they should do this for as long as it was reasonably necessary to determine the ownership of the money. Also, excess commission will not be client money (for MiFID business) where the firm has agreed, in advance with its client, that such money will be held as collateral to secure payment of future work. This must be done under a lawful collateral title transfer arrangement and the firm must act honestly, fairly and professionally.

8.7 In such circumstances, excess commission held by the firm will not be subject to the client money rules because such money would not fall within the definition of client money. The feedback we received agreed with our proposals, although some respondents requested further guidance on specific scenarios within their own business.

Q7. Do you agree with our proposals that will allow firms to hold excess commission outside MiFID's requirements for the safeguarding and administration of client money?

Our response: We will not provide further general guidance to firms on this subject. Firms can discuss matters of individual concern with their FSA supervisor. Accordingly, we confirm our proposal for the holding of excess commission in certain circumstances outside of the MiFID requirements for the holding of client money.

Personal investment firms temporarily handling financial instruments

8.8 We proposed including in CASS 6 a modified version of the rule which permits the temporary handling of client financial instruments by personal investment firms outside the client asset protections. Also, we will no longer limit this to personal investment firms.

> Q8. Do you agree that we should permit investment firms temporarily to handle financial instruments belonging to clients without being subject to the full ambit of the custody rules?
>
> Q9. Will the change to this rule have any unintended consequences for your firm, if you currently hold designated investments on a temporary basis?

8.9 The feedback we received generally agreed with our proposals, although some respondents requested further guidance on specific scenarios within their own business. Further, we note that firms did not identify any significant unintended consequences should firms hold designated investments on a temporary basis.

Our response: We will not provide further general guidance to firms on this subject. Firms can discuss matters of individual concern with their FSA supervisor, in the context of more principles-based regulation. We confirm our proposal to permit investment firms temporarily to handle financial instruments belonging to clients without being subject to the full range of the custody rules.

Private customers' stock lending and relevant collateral

8.10 Our existing rules provide that, for stock lending activity involving the custody investments of private customers, firms must ensure that relevant collateral is provided by the borrower to protect the customer's rights in the event of default. Our proposal was based on a principles-based approach, derived from the general duty to act in the best interests of a client. We put this together with guidance that we would expect a firm that engages in stock-lending activities with a retail client to ensure that relevant collateral were provided by borrower.

> Q10. In the absence of this rule, in what circumstances would you undertake stock lending activities for a retail client without ensuring that relevant collateral were provided by the borrower to protect the client's right?

Our response: Firms generally supported our approach. We therefore confirm our proposal.

Guidance on reconciliations and calculation

8.11 We proposed replacing the current prescriptive time limits for firms to undertake internal and external reconciliations in relation to client money and financial instruments with the flexibility to adopt a more principles-based approach and perform them 'as often as is necessary'.

> Q11. Will your firm make use of this flexibility or will you continue to reconcile under current timescales?

8.12 Firms indicated in their responses that they welcomed our proposal to provide added flexibility. However, a number of larger firms indicated that they would not utilise this added flexibility, as they currently reconcile on a daily basis. It would appear that the flexibility would be more relevant for smaller firms.

Our response: We confirm our proposal to provide firms with added flexibility for the timescale for performing reconciliations.

Money market funds

8.13 MiFID included an express provision that recognises that firms, when segregating client money, may place that money in a 'qualifying money market fund' (MMF). This fund must meet certain conditions listed in the Directive.

Q12. Will your firm use MMFs for the segregation of client money?

8.14 Respondents generally supported the use of MMFs. One respondent noted that it is appropriate where the firm would hold client money for a relatively long period of time, for example, to fund a tax bill in such a way that a client can obtain the maximum level of interest. The respondent also stated that clients might see this as a way of diversifying the risk of holding their client money away from a limited range of banks. Another respondent suggested that the guidance should emphasise more clearly that investment in a qualifying MMF is governed by the conduct of business rules.

8.15 Two respondents were not certain whether the assessment of a qualifying MMF as being suitable involved using a long or short-term rating. They considered that for this new provision to be meaningful, firms would need to be able to access funds with a high short-term rating. They noted that if firms are restricted to using long term ratings (AAA), there are so few funds with this rating that it would not be worthwhile using MMFs to segregate client money.

Our response: We agree that guidance should state clearly that the conduct of business rules would govern investment in a qualifying MMF. In determining whether short- or long-term ratings are appropriate in the assessment of suitability, we understand that CESR may consider this matter during the course of 2007, and firms may have an opportunity to consult with CESR on this.

Restrictions on the use of unregulated custodians

8.16 MiFID prohibits firms from depositing client financial instruments with an unregulated third party, in a jurisdiction where the safekeeping of financial instruments for the account of another person is subject to specific regulation and supervision. MiFID also prohibits firms from depositing client financial instruments with a third party in a third country that does not regulate the holding and safekeeping of financial instruments for the account of another person unless at least one of two conditions is met. We outlined this in CP06/14[30].

30 These are that (a) the nature of the financial instruments or of the investment services connected with those instruments requires them to be deposited with a third party in that third country; or (b) where the financial instruments are held on behalf of a professional client, that client requests the firm in writing to deposit them with a third party in that third country.

Q13. Will our proposals affect arrangements that firms currently have with unregulated custodians?

8.17 Two respondents queried the position on the use of non-regulated custodians. They were not certain whether our draft rules would need to be applied to all custodians forming part of a chain, which would require the firm to impose appropriate restrictions in the appointee's own sub-custody network.

8.18 One respondent also considered that professional firms, such as lawyers, should be allowed to act as custodians. The respondent claimed that it can be difficult for a private equity firm to identify appropriate depositaries because portfolios are composed of illiquid and unquoted stock. Many regulated institutions will either not provide this service or only do so at significant cost.

Our response: We understand that the relevant MiFID provision should also apply to sub-custodians appointed by a third party. Otherwise the requirement could be easily circumvented, which cannot be in line with the spirit of the Directive. In our view, a broader interpretation does not cause practical difficulties to firms for the following reasons:

(a) The restriction only applies where firms appoint a third party to safe-keep financial instruments in a jurisdiction that regulates and supervises this activity. This means that the restriction does not apply to those third parties (including sub-custodians) appointed in places where the activity is not regulated in the first place.

(b) It is unlikely that custodians will sub-delegate the safekeeping of financial instruments to sub-custodians located in another country.

(c) The rule does not prevent the use of unregulated fund registers, central securities depositories or unregulated nominee companies appointed by regulated sub-custodians that firms appoint. Accordingly, we confirm our approach to carry forward the existing rule.

With regard to the use of professionals, MiFID clearly sets out who can be a custodian and we do consider it appropriate in this instance, given the alternatives, to make an exception for professional firms such as lawyers.

Money received in a foreign currency

8.19 Our existing rules permit firms to segregate client money in a currency different from that of receipt, provided that the firm adjusts the balance on a daily basis. This ensures the client bears no currency risk and clarifies that the firm is not required to open a separate client money account for each currency. MiFID does not cover segregation of client money received in a foreign currency.

Q14. In the absence of this rule, would you pass on currency exposure to relevant clients?

Our response: MiFID does not enable us to maintain a specific exemption from the client assets rules where the firm is providing MiFID business and the client is an affiliated company. Therefore, firms will need to determine whether the services they provide to affiliated companies fall within the scope of MiFID. If they do, the requirements under the MiFID client money and custody rules will apply.

Other significant issues

A – Affiliated Companies

8.20 One respondent noted that under our existing rules, assets (investments or cash) belonging to affiliated companies are excluded from the client asset rules - unless the assets belong to an underlying client of the affiliate or the affiliate is being treated as an arm's length client of the firm. The respondent considered that the proposed rules now require all affiliated assets to be treated as those of the client.

8.21 As a result, the respondent was concerned that they would need to identify any assets held on behalf of an affiliate, which are currently excluded from segregation, and include such assets within the scope of the MiFID client asset rules.

Our response: We confirm that this was not the policy intention. It was our intention to maintain the status quo in line with our existing rules. We consider that where a company is an affiliate, no further protection is required.

B – Law Societies of England & Wales, Northern Ireland and Scotland

8.22 Solicitors are subject to additional statutory duties to protect money belonging to clients. Accordingly, we have exempted them from our client money regime, with the exception of the client money distribution rules, which apply in the event of the failure of the authorised professional firm or of a third party holding client money.

8.23 We anticipate that some member firms of the Law Societies will be within the scope of MiFID. The regime for safeguarding client assets under MiFID is more prescriptive than under the existing rules. As a result, we are continuing to liaise with the respective law societies to determine whether the societies' existing rules are sufficient. If the rules are not sufficient, we will work together with the Law Societies to identify the relevant additional MiFID provision/s which member firms will be subject to, and will consult during 2007. In the meantime, we propose that the minimum provisions necessary to implement MiFID will apply to members of the Law Societies that are MiFID firms.

C – Transfer of money to a third party

8.24 The proposed rule in CASS 7.5.2 will only be relevant where the money placed with a third party, including an exchange, clearing house or intermediate broker, is subject to the client money rules. This will not be the case if it is received by the firm by way of title transfer collateral.

8.25 We have provided guidance to firms on CASS 7.5.2R, to clarify our understanding of the rule. We consider that the rule sets out the requirements a firm must comply with when it transfers client money to a third party without discharging its fiduciary duty owed to that client. We understand that such circumstances arise when a firm passes client money to a third party (for example, in the form of initial or variation margin) in relation to obligations owed to the third party. In this context, the obligations referred to are intended to be those relating to transactions the firm undertakes for the underlying client.

D – Non-EEA Firms

8.26 One respondent suggested there was some uncertainty about the UK branches of non-EEA firms.

8.27 We note that credit institutions are investment firms if their business falls within the definition of an investment firm under MiFID. Such a credit institution will only be a MiFID investment firm if its 'home state' is in the EEA. If a credit institution is from a third country (for example, the USA, Japan or Switzerland), it would be a third country investment firm. These third country firms will continue to be subject to the non-directive client asset regimes in CASS 2 and 4.

E – Credit Institutions

8.28 In the case of UK credit institutions, the second limb of the definition of a 'MiFID investment firm' reflects that Article 1(2) of MiFID Level 1 limits the extent to which MiFID applies to credit institutions. Therefore, while they are caught by the Directive, this is only for certain purposes.

8.29 First, it provides that MiFID only applies to credit institutions 'when providing investment services or activities'. It does not apply when credit institutions are purely providing ancillary services, which is most likely relevant for a pure corporate finance, custody or possible investment research service. However, this will not prevent the rules applying where the ancillary service is combined within an investment service, for example, where a firm combines custody and brokerage services. Second, only certain provisions in MiFID apply to credit institutions, and these are listed in Article 1(2).

8.30 We note that the uncertainty for respondents was due to their understanding that if credit institutions were capable of being investment firms, these firms could fall within both the first and second limbs of the definition, which expressly refers to credit institutions, of a MiFID investment firm. To clarify this, we note that in such a case, the second limb of the definition should take precedence over the first. These include the client asset and conduct of business requirements.

F – Commodity Futures Trading Commission ("CFTC")

8.31 United States (US) legislation restricts the ability of non-US firms to trade on behalf of US customers on non-US futures and options exchanges. The relevant US regulator, the CFTC, operates an exemption system for firms we authorise. We sponsor the application from a firm for exemption from Part 30 of the General Regulations under the US Commodity Exchange Act in line with this system.

8.32 As a result, a firm with a Part 30 exemption order undertakes to the CFTC that it will refuse to allow any US customer to opt not to have his money treated as client money if it is held or received for transactions on non-US exchanges, unless that US customer is an eligible contract participant. The firm will also operate a London Metal Exchange (LME) bond arrangement for the benefit of US-resident investors.

Our response: CASS provides both rules and guidance on this. We understand that members of the LME are concerned about how the proposed changes to the client money rules will affect this exemption. We will continue to liaise with the CFTC to determine whether there is a need to incorporate such requirements into the FSA Handbook, in light that the requirements exist elsewhere. As part of this dialogue, we will be seeking input from the LME. We will continue to work on this matter and will provide an update during 2007.