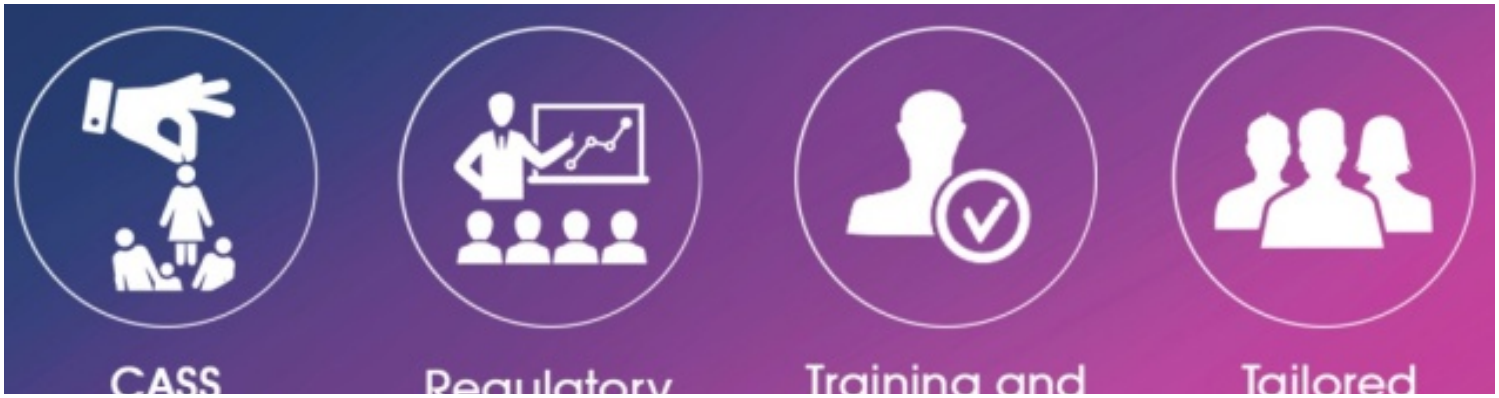
Rosediem Thought Leadership Paper:
The Client Assets ("CASS")
impact of MiFID II – PS 17/14

The FCA recently finalised their thoughts on how UK firms should be adopting the rule changes within MiFID II from a CASS perspective. PS17/14 hopefully saw the end to the speculation of CASS professionals and CASS Oversight Officers who were wondering whether MiFID II was going to be another PS14/9 grand scale change or whether the FCA would deem that the existing CASS rules largely cover the MiFID II requirements and therefore the CASS rules would persist as we know and love them now, with only minimal changes being made around the edges.



As always, the answer depends on the circumstance a firm is subject to, and the business activities that they undertake. In the market, we are seeing that most firms do not recognise the impact to them. Whilst for around half of the client firms we service the impact will be negligible, we believe that the other half is grossly underestimating the impact to them, which is likely to be quite substantial.

As well as encouraging you to dive into Chapter 4 of PS17/14 and the 41 pages of Annex H, that list out all the individual rule amendments, this paper hopes to inform you of the 'big-ticket' items that may affect you and your firm in the near future.

The rule changes required can be split out under the following seven headings:

1. Prohibition of Title Transfer Collateral Arrangements ("TTCAs") with retail clients and additional requirements for firms to consider the appropriateness of TTCAs for non-retail clients.

2. Firms will only be allowed to agree with a third party that custody assets can be used to satisfy a firm's obligations to that third party (for example, under a lien) if required to do so by law in a third country, and such arrangements must be recorded in client contracts. Liens, if required by the applicable law in the third country, may only be granted for 'properly incurred liabilities' which include debts over the clearing and settlement over the client assets only. Lien's or set-off arrangements are not permitted if they extend over and above these client related debts. Separately, there is a requirement for firms to ensure that ownership status of the assets is clear in client contracts and the firm's books and records.

3. An extension in safeguarding provisions to third party custodians who delegate to further sub-custodians. In line with MiFID II the FCA expects a firm subject to CASS to ensure its custody agreements only provide for

further delegation that complies with the MiFID II requirements on where assets can be held. MiFID II continues the existing MiFID requirement to ensure the custody chain comprises only regulated custodians (with only limited exceptions under certain conditions for professional clients).

4. A requirement to obtain express (two-way) client consent and to make internal assessments when placing a client's money in a Qualifying Money Market Fund ("QMMF"). The QMMF definition will continue to track the MiFID definition (as opposed to the ESMA definition) and units in QMMF's should be treated as safe custody assets whereas money is still to be treated as client money.

5. A relaxation of the rules on diversification of client money deposits allowing firm's classified as small firms (under the client money rules and excluding their custody balances) to qualify for an exemption from the current prohibition on depositing over 20% of client money in a group bank if they meet certain conditions.

6. A requirement for firms to have measures in place to prevent unauthorised use of client assets, including use of assets in omnibus accounts and in respect of commercial settlement systems. There is also clarification that risk disclosures required by COBS are not sufficient to satisfy the express consent requirement if these do not ensure two-way consent i.e. a wet signature.

7. A requirement for firms to ensure appropriate collateral is provided and monitor its continuing suitability when arranging securities lending for clients. This requirement covers both bilateral and tri-party arrangements.

Without taking each of the above in turn, we have selected a few topics that we feel require immediate attention.

For certain broker environments one of the most prominent of requirement is the obligation for Firms to terminate all existing TTCAs with retail clients, as retaining them is contrary to MiFID II. Any firms that have these arrangements and right to use arrangements with retail clients will need to develop a plan to unwind positions and/or re-structure these product lines. This is not easy to do in practice as client best interests will also need to be considered and we suspect that meeting the MiFID II deadline will require some heavy upfront planning and operational effort. Firms are also reminded that these prohibitions equally apply to TTCA's over non-cash collateral positions which again will not be easy to unwind and/or restructure.

In addition to the above, firms with TTCA arrangements in place with non-retail clients will no longer be able to apply blanket TTCA's and instead will be required to make an assessment of whether collateral taken 'far exceeds' the client's obligation. This assessment should be considered at a client level and therefore firms will need to design a mechanism to manage this going forward. Any such assessment may also produce the result that certain positions or product lines need to be unwound or restructured. Firms will also be required make increased risks disclosures, although it may combine its client communication regarding TTCA risks with its communications made under Securities Financing Transaction Regulation ("SFTR") Article 15.

If you wish to work through the implications of the TTCA restrictions on your firm please feel free to contact us.

Another of the key challenges presented by the new rules is around how firms can be seen to adhere to the enhanced requirements related to the prevention of unauthorised use of one client's assets for an another's trade. Allowing this behaviour to occur in an unchecked manner is a breach of the existing CASS rules but the FCA interpretation of MiFID II take firms' responsibility for this behaviour further, even leading correspondents to the MiFID consultation papers to

question whether the FCA is expecting firms to scrap omnibus client accounts with custodians and CSDs such as CREST.

On this topic, the FCA has stated that it expects firms ensure they take 'appropriate measures' to ensure that one clients assets are not used for another, and that firms must be able to evidence these measures if required. This includes trading on commercial settlement systems, where the existing and new rules prevent use of one client's assets for another's trade unless the relevant client has given express prior consent. For retail clients, a firm cannot use assets at all except for securities financing transactions and with prior express consent, therefore appropriate controls must be in place to prevent the use of client assets. The FCA stipulate that MiFID II does not mandate pre-funding and appropriate measures could include a policy for dealing with trades that do not settle as expected, an extension of current custody shortfalls processes, and other such controls. In practice given the existing infastructure within systems and the mechanics of how omnibus accounts operate, we envisage that this requirement will not be straightforward to implement.

Additionally, under the new rules client contracts should now allow clients to make an informed choice as to how their assets will be managed throughout the trade cycle. Firms should agree with their clients the actions they will take, in order to comply with the CASS rules and stipulations in MiFID II. This entails firms obtaining express consent from their clients rather than the one-way notifications and disclosures typically employed across the industry at present. (The FCA have clearly stated that they do not consider disclosures, made in client documentation, as meeting these requirements.

Overall the increased levels of client consent and disclosures required as part of MiFID II will more than likely require another round of painful repapering for firms. Under this new express consent requirement, we envisage that this round will be more painful than most firms expect and as such work on this should commence as soon as possible to avoid missing the deadline.

If you wish to discuss the actual changes required and the operational impact please do not hesitate to get in touch with us as we are well placed to work with both external and internal counsel on these changes.

Finally, guidance was given to clarify that the single officer responsible for safeguarding of client assets can undertake additional responsibilities where appropriate for the firm. Notwithstanding this new clarification we would advise all firms to formally evaluate this decision with evidence presented to its relevant governance forums. The FCA will further consider the integration of the single CASS Officer requirement and SCMR within the context of investment firms as this consultation progresses this year.

Should any of the above have peaked your interest or should you wish to discuss and / or work through the CASS impact of MiFID II to your firm please do not hesitate to get in touch by email or by leaving a message on the website and one of our team will get back to you.

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