Briefing: MiFID II - Safeguarding of financial instruments and funds belonging to clients

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*MiFID II will be implemented into UK law on 3 January 2018 and will replace Directive 2004/39/EC (**MiFID I**). MiFID II aims to enhance the efficiency and integrity of the financial markets across the European Union and we have prepared a suite of briefings on key areas of change. This briefing focuses on the proposed strengthening of the protection of investors under MiFID II and the resultant changes to FCA rules as set out in the FCA's recent Consultation Paper CP16/19. We also consider the practical impact of these proposals for UK firms.*

1. Background

MiFID II is made up of two parts, the MiFID II directive (2014/65/EU) and the MiFIR regulation (2014/600/EU), which together are referred to as MiFID II in this briefing. MiFIR is a regulation and therefore is directly applicable in each member state. MiFID II itself as a directive requires implementation at a national level.

The high level obligations under MiFID I to have in place adequate arrangements to safeguard a client's ownership rights and to prevent the use of a client's instruments on the firm's own account (except with the client's express consent) remain largely unchanged under MiFID II. However, how firms are expected to achieve this is more detailed under MiFID II and, following ESMA's technical advice, the applicable rules relating to investor protection have been enshrined in new rules published by the Commission (Commission Delegated Regulation 2016/2398 and the Commission Delegated Directive 2016/2031).

2. FCA's approach to implementation

The FCA's existing rules for safeguarding and protecting client assets and money are set out in the Client Assets sourcebook (**CASS**) and apply (with the exception of some minor differences in relation to non-MiFID business) to all designated investment business.

The FCA has reviewed the new MiFID II requirements against CASS and has published its approach to implementing any required changes in its Consultation Paper, FCA CP 16/19 (**CP 16/19**). In relation to changes that are required to CASS, the FCA has noted that most of the MiFID II requirements are already in place. As such, the FCA's approach will be to retain the single CASS sourcebook and to transpose additional new requirements through "intelligent copy-out", by adhering closely to the text of MiFID II save where it is necessary to use alternate wording to

align with UK law and practice. The FCA has also confirmed that all new MiFID II rules not currently in CASS will apply to all designated business (including non-MiFID business), although the FCA has indicated that it will continue to allow professional clients of non-MiFID firms to opt out of the client money rules chapter.

3. Responsibility for CASS oversight

What's changing?

Existing CASS rules require a firm to appoint a director or senior manager to have responsibility for oversight of the firm's operational compliance with CASS. MiFID II has highlighted the importance of this role and the CASS rules will be clarified to emphasise that a firm will only be able to allocate this role to a single director or senior manager. Additionally, in line with the importance attached to this role, MiFID II makes it clear that the person with CASS oversight responsibility should not be given any other roles or responsibilities unless the firm is satisfied that the person will still be able to discharge their CASS duties effectively. In particular the FCA recognises that this may be the case in small and non-complex firms where the individual carrying out the CASS oversight function may also have additional responsibilities.

Implications for firms

In practice the CASS oversight role is not being substantially changed but firms should review the scope of responsibilities allocated to their CASS oversight person and, particularly in the case of medium, large or complex firms, where such responsibilities extend beyond those related to the CASS operational oversight, the firm may need to reallocate the additional responsibilities.

4. Title Transfer Collateral Arrangements (TTCAs)

What's changing?

TTCAs are used by firms that enter into collateralised transactions with clients. Under a TTCA, the firm is able to treat the margin or collateral as its own working capital and not as client money. As a result the firm is not obliged to segregate the margin and in the event of the firm's collapse the TTCA can have the effect of making such a client an unsecured creditor of the firm. MiFID II introduces two key changes in relation to the use of TTCAs.

The first is a complete prohibition on the use of TTCAs with retail clients. Given the insolvency risk associated with TTCAs the ban is being introduced to protect retail clients, who are considered to be less likely to understand the nature of such risks. In reality, such contracts are rarely used with retail clients in the UK as the FCA has already heavily restricted the use of TTCAs with retail clients in relation to contracts for differences, spread-betting and rolling spot forex. The ban comes into effect on 3 January 2018 and a firm will be expected to terminate any TTCAs entered into with a retail client by this date. In the period up to 3 January 2018 firms will therefore need to review if it has TTCAs in place with retail clients and, if it does, the firm will need to terminate them.

The second change is in relation to non-retail clients and in this regard a firm will only be able to use a TTCA where the firm has:

- disclosed the risks involved with a TTCA and the effect of the TTCA on the client's assets or money; and
- assessed the appropriateness of the TTCA for the client. For a TTCA to be deemed appropriate, the firm will be required to consider a range of factors including the connection between the client's liability to the firm and the need to use TTCAs and the extent by which the amount of client money or assets subject to the TTCA exceed the client's liability to the firm.

These changes are designed to prevent the blanket use of TTCAs for non-retail clients and firms will be expected to demonstrate compliance with these requirements.

Implications for firms

Firms will no longer be able to use any TTCAs with retail clients. Firms who use TTCAs with non-retail clients will have to:

- ensure that the risk warnings it has provided to the client are clearly documented and recorded;
- put in place a clear procedure for identifying the factors the firm must take into account when considering appropriateness and for recording the results of this assessment; and
- review TTCAs at regular intervals to ensure that the above requirements are met consistently.

5. Delegation to sub-custodians

What's changing?

The application of the existing CASS requirements that:

- custody assets may only be deposited with a third party in a jurisdiction that supervises and regulates safekeeping; and
- assets are only deposited with a third party in a non-EEA jurisdiction where the nature of the asset requires it or where a professional client has requested it,

are being extended under MiFID II so that the requirements will also apply to delegates of a third party custodian.

The effect of this extension is that it will be possible for more than one firm in a chain of custody to be subject to the CASS rules in respect of the same financial instrument.

Implications for firms

Firms will need to:

- put in place systems for ensuring that a third party it appoints uses the required criteria when appointing a delegate; and
- ensure that this obligation is reflected in its custody agreement with the third

party.

6. General custody liens

What's changing?

CASS already limits the use of general liens save where such a lien arises as a result of applicable law in a jurisdiction outside the UK or is necessary to gain access to the local market in that jurisdiction. MiFID II is narrowing the scope of general liens even further such that they will only be permissible in circumstances where the lien is required as a result of applicable law in the third-country where the asset is held. As before, a firm will need to determine that holding the assets subject to the lien is in the client's best interests. This determination will now need to be made for all clients, as professional clients will no longer be able to instruct a firm to waive this protection. Liens which are confined to properly incurred charges and liabilities arising from the provision of custody services will be unaffected by these changes.

Firms will also need to disclose information about the lien to the client so that the client is informed of the risks associated with the arrangements. MiFID II applies the restriction on general liens to client money accounts held with third parties as well as to safe custody accounts and the FCA has therefore proposed new rules in CASS 7.11, on the same basis as those applicable to safe custody assets, to deal with this.

Implications for firms

Firms will need to review their arrangements with custodians outside the UK and, where a lien has been granted, firms will need to:

- assess whether holding the client money or asset subject to the arrangement is in in the best interests of the affected clients, including professional clients; and
- update their client documentation to record that a lien has been granted and to clarify the ownership status of assets subject to the lien in the event of the custodian's insolvency.

7. Unauthorised use of client assets

What's changing?

MiFID II expects firms to put in place arrangements to prevent the unauthorised use of a client's assets. In particular:

- where a client has given explicit consent that his assets may be used for stock lending a firm must ensure that a borrower of the client's assets will provide appropriate collateral. A firm is then expected to monitor the continued appropriateness of the collateral and take the necessary steps to maintain the balance with the value of the client's safe custody assets; and
- in relation to the settlement of transactions a firm will be expected to monitor the ability to deliver securities on the settlement date and to have in place remedial measures if this cannot be done, for example by borrowing corresponding securities, requesting prompt delivery of undelivered securities

or unwinding the position.

Implications for firms

The FCA expects that firms will already have adequate procedures in place to meet these requirements, but it may be necessary to check client documentation to ensure that it correctly records any express consents given by the client as to the use of assets, for example permission to lend stock and how the firm will deal with potential security shortfalls.

8. Diversification of client money

What's changing?

CASS currently prohibits firms form depositing more than 20% of client money into a relevant group entity. MiFID II applies a similar prohibition but allows a relaxation of the rule where to comply would be disproportionate in view of the following factors:

- the small balance of client money held;
- the nature, scale and complexity of the firm's business; and
- the safety offered by the third parties.

If a firm intends to apply this exemption the firm must carry out an assessment of the facts and such assessment will have to be repeated periodically. The firm will also have to notify the FCA of the initial and periodic assessments.

Implications for firms

In CP16/19, the FCA explained that it only expects small CASS firms to be able to apply the exemption and the revised CASS rules are drafted on this basis. As such, the change in relation to diversification is not expected to impact most firms, but small firms may want to consider whether the exemption will be applicable to and helpful for them. If so, such firms will need to implement a procedure for assessing the relevant facts on a periodic basis and notifying the same to the FCA.

9. Placing client monies into qualifying money market funds (QMMFs)

What's changing?

Under MiFID I if a client did not want their money placed in a QMMF, it was obliged to actively oppose such segregation of their funds in a QMMF but under MiFID II the shift is towards active, positive consent from the client. Before the client can give express consent, the client (as is the case now) must be told that funds placed in a QMMF will not be held in accordance with the client money rules. Further, firms will need to carry out an internal firm assessment when depositing client money in a QMMF as they will no longer be able to solely rely on credit rating agency's rating of a QMMF.

Implications for firms

Firms should review their client documentation to ensure that the required information

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is provided to the client and that the client has expressly consented to the placement of funds in a QMMF. If this is not the case, firms should amend their client agreements accordingly. Firms will also need to put in place or review their internal assessment procedures for placing client monies into QMMFs.

10. Conclusion and next steps

A number of the changes being introduced under MiFID II in relation to the protection of client assets have already been implemented in CASS by the FCA and the impact for firms will generally be limited. Where necessary, firms should review client documentation to ensure that the relevant consents and information are clearly specified and that policies and procedures reflect the MiFID II requirements. In our view the most significant impact MiFID II will have in relation to the safeguarding of client assets and client money will be with regard to TTCAs, in particular the new appropriateness assessment of TTCAs when dealing with non-retail clients. Firms whose clients have approved the use of their assets for stock lending purposes, may also be materially affected by the changes and should review their arrangements for triggering a request for additional collateral to ensure they meet the standards required.

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