Notification and justification for the UK Financial Conduct Authority's ("FCA's") requirements relating to safe custody assets and client money, under Article 4 of Directive 2006/73/EC ("Level 2 Directive") implementing Directive 2004/39/EC ("Level 1 Directive")

1. The FCA, which is the competent authority for the purposes of the Level 1 and Level 2 Directives, has in the course of wider reforms decided to introduce four new provisions to improve the protection of safe custody assets and client money, which are further explained below and in Policy Statement 14/9.[1] Each of these provisions will only apply to firms for which the UK is the home Member State. They relate to:

    A. disclosure of information to retail and non-retail clients relating to client money and safe custody asset arrangements;
    B. written agreements between a firm and any third party with whom it deposits safe custody assets;
    C. procedures for the termination of title transfer collateral arrangements; and
    D. requirements on firms who wish to dispose of safe custody assets which have been unclaimed by clients

    (each a "Provision" and together the "Provisions").

2. Article 4 of the Level 2 Directive sets out the conditions which must be satisfied if a Member State intends to retain or impose any requirements additional to those of that directive. This notification of the Provisions is made in accordance with those conditions and explains how the Provisions satisfy the Article 4 conditions.

3. This notification is structured as follows:

    - explanation of how the Provisions may be additional to the requirements of the Level 2 Directive;

[1] http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-09

- description of the specific risks to safeguarding safe custody assets and client money and to market integrity in the UK addressed by the Provisions and/or how they address risks which became evident post-MiFID and which are not otherwise regulated by or under Community measures;
- explanation of why the Provisions are proportionate; and
- explanation of why the Provisions do not restrict or otherwise affect the rights of firms under Articles 31 and 32 of the Level 1 Directive.

Explanation of how the Provisions may be additional to the requirements of the Level 2 Directive.

Provision A - Disclosure of information to retail and non-retail clients relating to client money and safe custody asset arrangements

4. The rules concerning Provision A can be found in Policy Statement 14/9 at CASS 9.4.1G to 9.4.4G. They will come into effect on 1 December 2014, subject to a transitional provision which has the effect that firms are only required to comply with the provision during the period between 1 December 2014 to 1 June 2015 in respect of clients they take on during that period or, in respect of a client taken on before that period, where they materially amend the terms governing their relationship with the client during that period (the transitional provision can be found in Policy Statement 14/9 at CASS TP1.1.12A). The rules will have full effect for all firms and in respect of any client from 1 June 2015.

5. The relevant EU legislative provisions for Provision A are in the Level 2 Directive, at Articles 29(2), 29(3), 30(1)(g) and 32:

   Level 2 Directive Article 29(2): "*Member States shall require investment firms, in good time before the provision of investment services or ancillary services to retail clients or potential retail clients, to provide the information required under Articles 30 to 33.*"

   Level 2 Directive Article 29(3): "*Member States shall require investment firms to provide professional clients with the information referred to in Article 32(5) and (6) in good time before the provision of the service concerned.*"

   Level 2 Directive Article 30(1)(g): "*Member States shall require investment firms to provide retail clients or potential retail clients*

with the following general information, where relevant: … (g) if the investment firm holds client financial instruments or client funds, a summary description of the steps which it takes to ensure their protection, including summary details of any relevant investor compensation or deposit guarantee scheme which applies to the firm by virtue of its activities in a Member State; …"

Level 2 Directive Article 32:

"1. Member States shall ensure that, where investment firms hold financial instruments or funds belonging to retail clients, they provide those retail clients or potential retail clients with such of the information specified in paragraphs 2 to 7 as is relevant.

2. The investment firm shall inform the retail client or potential retail client where the financial instruments or funds of that client may be held by a third party on behalf of the investment firm and of the responsibility of the investment firm under the applicable national law for any acts or omissions of the third party and the consequences for the client of the insolvency of the third party.

3. Where financial instruments of the retail client or potential retail client may, if permitted by national law, be held in an omnibus account by a third party, the investment firm shall inform the client of this fact and shall provide a prominent warning of the resulting risks.

4. The investment firm shall inform the retail client or potential retail client where it is not possible under national law for client financial instruments held with a third party to be separately identifiable from the proprietary financial instruments of that third party or of the investment firm and shall provide a prominent warning of the resulting risks.

5. The investment firm shall inform the client or potential client where accounts that contain financial instruments or funds belonging to that client or potential client are or will be subject to the law of a jurisdiction other than that of a Member State and shall indicate that the rights of the client or potential client relating to those financial instruments or funds may differ accordingly.

6. An investment firm shall inform the client about the existence and the terms of any security interest or lien which the firm has or may have over the client's financial instruments or funds, or any

right of set-off it holds in relation to those instruments or funds. Where applicable, it shall also inform the client of the fact that a depository may have a security interest or lien over, or right of set-off in relation to those instruments or funds.

7. An investment firm, before entering into securities financing transactions in relation to financial instruments held by it on behalf of a retail client, or before otherwise using such financial instruments for its own account or the account of another client, shall in good time before the use of those instruments provide the retail client, in a durable medium, with clear, full and accurate information on the obligations and responsibilities of the investment firm with respect to the use of those financial instruments, including the terms for their restitution, and on the risks involved."

6. These articles have been implemented by the UK through the FCA's conduct of business rules in the FCA Handbook, specifically at COBS 6.1.7R.[2]

7. Provision A creates two new requirements that build on the MiFID provisions set out above, only the second of which is considered additional for the purposes of Article 4 of the Level 2 Directive. These two new requirements are as follows:

    a. Under Provision A, the information required to be provided under COBS 6.1.7R in respect of 'designated investments', would also need to be provided in respect of 'any custody assets'. The definition of custody assets for the purposes of the FCA's Handbook of Rules and Guidance is wider than 'designated investments', and can for example include chattels such as artworks or crates of wine held by a firm in the same portfolio as other designated investments, such as shares and bonds (so such chattels would not, for MiFID purposes, be financial instruments).[3]

    b. Also under Provision A, the resulting aggregate information requirement (including both the information required to be notified under COBS 6.1.7R and the information described in

[2] See http://fshandbook.info/FS/html/handbook/COBS/6/1

[3] The FCA's custody rules already have application to 'custody assets' in a manner appropriate to the nature of and value of the custody assets (See CASS 6.1.1BR here: http://fshandbook.info/FS/html/handbook/CASS/6/1). The FCA considers that information requirements detailed in COBS 6.1.7R should apply equally to both types of investments held by a firm for a client.

paragraph 7.a above), would apply in respect of all clients, regardless of whether they are retail or not.

8. The widening of the information requirement, under Provision A, to apply to all clients is considered to be additional because, under the Level 2 Directive, where a firm holds designated investments or client money for a non-retail client it is only required to provide certain types of information (see Articles 29(3), 32(5) and 32(6)). Firms affected by Provision A would no longer be able to provide non-retail clients with a sub-set of the types of information on the safeguarding of custody assets and client money that they are required to provide to retail clients – rather they would have to provide all clients with the same types of information.

9. Following the insolvency of Lehman Brothers International (Europe) ("LBIE") and other similar recent cases clients may be unclear as to the status of their assets and money following a firm's insolvency if they have only received (prior to the insolvency) limited information regarding arrangements for their assets and client money. Therefore, the FCA considers that any benefit (under the current requirements) in allowing a firm to communicate only limited types of information to non-retail clients would be outweighed by the potential harm to those clients in the event of the firm's insolvency. In light of recent experience and to prevent investor harm, there should be no difference in treatment based on the firm's categorisation of the client.

Provision B - Written agreements between a firm and any third party with whom it deposits safe custody assets

10. The rules concerning Provision B can be found in Policy Statement 14/9 at CASS 6.3.4AR to 6.3.4BG. They will come into effect on 1 December 2014, subject to a transitional provision which has the effect that firms are only required to comply with the provision during the period between 1 December 2014 to 1 June 2015 in respect of arrangements with third parties for the depositing of clients' safe custody assets entered into during that period or, in respect of an arrangement that commenced before that period, where they materially amend the arrangements during that period (the transitional provision can be found in Policy Statement 14/9 at CASS TP1.1.7C). The rules will have full effect

for all firms and in respect of any arrangement with a third party for the depositing of clients' safe custody assets from 1 June 2015.

11. The relevant EU legislative provisions for Provision B are in Article 13(7) of the Level 1 Directive and Article 17(1) of the Level 2 Directive:

Level 1 Directive Article 13(7): *"An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent."*

Level 2 Directive Article 17(1): *"Member States shall permit investment firms to deposit financial instruments held by them on behalf of their clients into an account or accounts opened with a third party provided that the firms exercise all due skill, care and diligence in the selection, appointment and periodic review of the third party and of the arrangements for the holding and safekeeping of those financial instruments.*

In particular, Member States shall require investment firms to take into account the expertise and market reputation of the third party as well as any legal requirements or market practices related to the holding of those financial instruments that could adversely affect clients' rights."

12. Provision B explicitly requires firms that deposit safe custody assets belonging to clients with a third party to enter into a written agreement with the third party which contains the binding terms of the arrangement and, at minimum, clearly sets out the custody service(s) that the third party is contracted to provide.

13. The FCA has observed that in certain cases firms which deposit safe custody assets belonging to clients with third parties do not have a written agreement in place with the relevant third party. This is, in particular, often the case where the third party is another entity in the firm's group.

14. The FCA considers that a lack of adequate (or indeed any) contractual documentation governing the depositing of a client's safe custody assets with a third party under these rules can create uncertainty in the event of a firm's failure, leading to disputes over the responsibilities and obligations of the persons involved in the resulting 'chain of custody'. This can potentially lead to a delay in the return of the safe custody assets to the relevant clients after the firm's failure - during which these responsibilities and obligations may need to be settled. The resulting potential for such uncertainty presents a risk to investor protection.

15. Provision B could be argued to be consistent with, and within the scope of, Article 13(7) of the Level 1 Directive – which uses the wide words "*adequate arrangements*".

16. The requirement in Article 17(1) of the Level 2 Directive requires firms to exercise "*all due skill, care and diligence*" in the "*appointment*" of the third party. So there is a strong argument that a Member State, in choosing a form and method to achieve the result required by Article 17(1), may determine that, as a necessary minimum, exercising "*all due skill, care and diligence*" must involve the firm drawing up and entering into an agreement under which the third party would be appointed, and that such an agreement must set out the custody service(s) that the third party is contracted to provide.

17. However, it is noted that the Level 2 Directive does, elsewhere, expressly provide for written agreements in other contexts (for example, at Article 14(3)). Therefore, the UK has included Provision B in this notification on a precautionary basis, in case it is deemed to be an additional requirement requiring justification under Article 4.

Provision C - Procedures for the termination of title transfer collateral arrangements

18. The rules concerning Provision C can be found in Policy Statement 14/9 at CASS 6.1.8AR to 6.1.8EG (in relation to safe custody assets) and at CASS 7.11.9R to 7.11.13G (in relation to client money). They will come into effect on 1 June 2015.

19. The relevant EU legislative provisions for Provision C are in Articles 13(7) and 13(8) of the Level 1 Directive:

Level 1 Directive Article 13(7): *"An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent."*

Level 1 Directive Article 13(8): *"An investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights and, except in the case of credit institutions, prevent the use of client funds for its own account."*

20. It is noted that the protections under Articles 13(7) and (8) only apply where a firm holds financial instruments or funds that belongs to its client. Therefore, in circumstances where a client transfers ownership of financial instruments or funds to the firm, those MiFID protections are not required to be applied. An example of such a situation is where a client transfers full ownership of his/her property (financial instruments or funds) to the firm as collateral to cover present or future, actual, contingent or prospective obligations. This is recognised at Recital 27 of the Level 1 Directive:

Level 1 Directive Recital 27: *"Where a client, in line with Community legislation and in particular Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (12), transfers full ownership of financial instruments or funds to an investment firm for the purpose of securing or otherwise covering present or future, actual or contingent or prospective obligations, such financial instruments or funds should likewise no longer be regarded as belonging to the client."*

21. In the course of supervision the FCA has observed that, depending on the commercial context of dealings between a client and firm (for example the nature of the instruments in which transactions are entered into, and the venues at which transactions are completed or cleared through), it may be possible for a client to negotiate with the firm the contractual position as to whether or not the client's assets and/or money are to be transferred to the firm as

collateral, or held by the firm but remaining in the client's ownership (potentially subject to a security interest in favour of the firm, such as a charge). In the latter situation the protections under Articles 13(7) and 13(8) of the Level 1 Directive would be required to apply (subject to the operation of any other exclusion).

22. The FCA has also observed that in cases where a firm subject to the rules for safe custody asset and client money protection is facing financial difficulty, clients who have previously agreed with the firm that their assets or money are to be transferred to the firm as collateral may seek to renegotiate their contracts with the firm, with the effect that the title to the relevant assets or money are transferred back to the client, but they remain in the custody of the firm.

23. The FCA has observed that such renegotiations may take place as a matter of urgency, may be agreed between the client and firm verbally over the telephone, and may not be accurately reflected in the firm's books and records and/or given full operational effect through any necessary transfers of title before the collapse of a firm. In such circumstances, following the firm's failure, there may scope for a dispute as to whether or not the renegotiations resulted in a binding variation of the agreement between the firm and client that the firm (or an insolvency practitioner) would need to have regard to. It may take significant efforts (and potentially litigation) to determine whether a client is an unsecured creditor for the assets/money that he transferred to the firm as collateral, or (if the renegotiation is deemed to have been successful) has an entitlement to share in a distribution of the firm's safe custody asset estate or client money estate (which, in the UK, are typically both 'ring-fenced' from creditor claims).

24. The FCA has observed that such situations can lead to uncertainty, confusion and (until the correct position is established) significant delay (potentially a matter of a few months - but conceivably longer for a complex firm with a large client base) in the distribution of a failed firm's safe custody asset or client money estate. The FCA considers that delay of this sort is detrimental to the interests of a firm's client base as a whole.

25. To address this, Provision C requires the following procedure to be followed in order for assets or money, which were purportedly originally transferred to a firm, to be capable of falling within the scope of the rules for safe custody asset and client money protection:

a. both of the following must be recorded in writing by the firm:
    i. the request from the client to change the arrangement so that it comes within the protections of those rules;
    ii. any response from the firm agreeing to (or refusing) the client's request;
b. the firm's response (if agreeing) must clearly state when the change in arrangement is to take effect;
c. in respect of client money, the change in arrangement will be deemed to have taken effect from either the earlier of:
    i. one business day after the time stated in the firm's response; or
    ii. if no time was stated in the firm's response, from the business day after the firm's response was given.

26. It is considered that the procedure described above will, in the event of the failure of a firm, contribute towards an orderly wind-down, with a reduction in uncertainty and in the sort of delay described at paragraph 24 above.

27. There would appear to be a strong argument for the procedure described above to be viewed as in line with Articles 13(7) and 13(8) of the Level 1 Directive, and not additional to any requirement in the Level 2 Directive (which does not seek to impose any procedure of this sort). According to Articles 13(7) and 13(8) of the Level 1 Directive, the protections conferred by MiFID are to apply where an investment firm holds assets/money belonging to a client. Under Provision C, the protections under the relevant rules could not apply unless and until a written 'promise' made by the firm to hold the assets or money on that basis has taken effect. Provision C therefore simply seeks to add clarity as to when those protections might be relied on, rather than amending or increasing the requirements on firms once the protections have come into effect.

28. However, given the degree of prescription (which is necessary to achieve the desired legal certainty) in Provision C, the UK has included it in this notification on a precautionary basis, in case it is deemed to be an additional requirement requiring justification under Article 4.

Provision D - Requirements on firms who wish to dispose of safe custody assets which have been unclaimed by clients

29. The rules concerning Provision D can be found in Policy Statement 14/9 at CASS 6.2.8G to 6.2.16G. They will come into effect on 1 December 2014.

30. The relevant EU legislative provisions for Provision D are in Article 13(7) of the Level 1 Directive and Article 16(1)(f) of the Level 2 Directive:

Level 1 Directive Article 13(7): *"An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent."*

Level 2 Directive Article 16(1)(f): *"Member States shall require that, for the purposes of safeguarding clients' rights in relation to financial instruments and funds belonging to them, investment firms comply with the following requirements: … (f) they must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of client assets, or of rights in connection with those assets, as a result of misuse of the assets, fraud, poor administration, inadequate record-keeping or negligence."*

Level 2 Directive Article 16(2): *"If, for reasons of the applicable law, including in particular the law relating to property or insolvency, the arrangements made by investment firms in compliance with paragraph 1 to safeguard clients' rights are not sufficient to satisfy the requirements of Article 13(7) and (8) of Directive 2004/39/EC, Member States shall prescribe the measures that investment firms must take in order to comply with those obligations."*

31. Under Provision D a firm would be permitted (but is not required) to sell unclaimed safe custody assets at market value and donate the proceeds to a charity (or simply pay those unclaimed custody assets away to the charity), provided that:
    a. doing so is permitted by law and consistent with the arrangements under which that safe custody asset is held;
    b. the firm has held that safe custody asset for at least 12 years and in the 12 years preceding the divestment of that safe custody asset, it has not received instructions concerning any safe custody assets from or on behalf of the client concerned;
    c. the firm can demonstrate that it has taken reasonable steps to trace the client concerned to return the safe custody assets (which will include making reasonable attempts to contact the client or draw to their attention the proposed disposal of the assets); and
    d. the firm unconditionally undertakes to pay the client, in the event of the client seeking to claim the safe custody asset in the future, a sum equal to the value of the safe custody asset at the time it was liquidated or paid away - or procuring such an undertaking from a group company.

32. In the course of supervision the FCA has been approached by a number of firms which have been unable to return safe custody assets to clients for various reasons. Provided the requirements set out at 31 above are met, the FCA considers that Provision D amounts to a proportionate regulatory response to an issue that may, because of the costs of providing custody in perpetuity, be creating inefficiencies.

33. There would appear to be a strong argument that Provision D, by substituting whatever personal or contractual rights a client may have had in respect of safe custody assets held by the firm, with a right to claim against an unconditional undertaking for the value of an asset that was disposed of only after 12 years have elapsed and appropriate enquiries have been made, is a proportionate means of securing investor protection, and is not incompatible with Article 13(7) of MiFID, which refers to "*adequate arrangements*".

34. Under Article 16(1)(f) of the Level 2 Directive, firms are required to introduce adequate organisational arrangements to minimise the risk of the loss or diminution of clients' assets. It is

acknowledged that a client subsequently claiming against the firm's undertaking given under Provision D may argue that, as a result of the firm's compliance with Provision D, he has lost the benefit of any appreciation in value that the safe custody asset might have attracted following the firm's donation to charity (which the firm's undertaking does not cover). However, under that scenario the safe custody asset might equally have depreciated following the disposal and donation (which would only have been undertaken after the client had proven to be uncontactable).

35. Therefore, the FCA considers there to be strong arguments for Provision D to be viewed as compatible with Article 13(7) of the Level 1 Directive. However, given the prescriptive requirements on firms who wish to dispose of unclaimed safe custody assets, the UK has included it in this notification on a precautionary basis, in case it is deemed to be an additional requirement requiring justification under Article 4.

Description of the specific risks to safeguarding safe custody assets and client money and to market integrity in the UK addressed by the Provisions and/or how they address risks which became evident post-MiFID and which are not otherwise regulated by or under Community measures.

36. Following the implementation of MiFID and in the aftermath of investment firm failures in the UK (such as LBIE) and the increased focus on client assets protection, we have carried out a comprehensive review of our safe custody asset and client money rules for investment firms. This review has resulted in rule amendments to address lessons learnt from these investment firm failures, feedback from the industry and observations by the FCA's specialised client assets team.

37. Protecting safe custody assets and client money is fundamental to consumers' rights and the trust they place in firms; it is at the heart of ensuring a well-functioning and robust market place.

38. **Provision A – Disclosure of information to retail and non-retail clients relating to client money and safe custody asset arrangements** - In our experience of recent firm failures, we observed among clients misconceptions around the protections

afforded to their client money and safe custody assets. Clients of all types failed to understand the protections available for their monies and assets under the FCA's safe custody asset and client money rules and the impact contractual terms have on these protections. Where there is a lack of understanding amongst clients as to the level of protection afforded to their monies and assets there is a risk that disputes and queries will arise during insolvency proceedings that could delay or reduce the distribution of safe custody assets and client money for all clients.

Provision B - Written agreements between a firm and any third party with whom it deposits safe custody assets - We observed firms failing to adequately document the terms upon which safe custody assets are held with third parties. This creates uncertainty as to how the safe custody assets should be treated in the event of a firm's failure. There is the potential for disputes over the responsibilities and obligations of the different parties involved in the chain of custody over the safe custody assets. Moreover, in UK insolvency proceedings, the costs of distributing safe custody assets are usually allocated to the owners of those assets. As a result, any disputes or other difficulties in establishing clients' rights over safe custody assets can lead to a delay or reduction in the amount of assets available for distribution to the relevant clients after the firm's failure. The resulting potential for such uncertainty presents a risk to investor protection.

39. **Provision C - Procedures for the termination of title transfer collateral arrangements** - We observed that in situations where a firm is approaching insolvency there may be demand from clients to move money or assets that have previously been transferred to the firm as collateral so that the money and assets are subject to protection under the FCA's client money or safe custody assets rules. We have seen clients seeking to renegotiate their contracts such that the title to the relevant assets or money are transferred back to the client, but remain in the custody of the firm and are protected by the client money or safe custody asset rules. This provides the potential for disputes as to the status of the money and assets to arise when firms enter into insolvency proceedings, for example in circumstances where client agreements were not updated adequately, where clients instructions

were not followed (and their money or assets not segregated), or where the firm did not make the necessary changes in its records.

40. It may take significant efforts and litigation to determine whether a client is an unsecured creditor for the assets/money that he transferred to the firm as collateral, or (if the renegotiation is deemed to have been successful) has an entitlement to share in a distribution of the firm's safe custody asset or client money estate. Moreover, in UK insolvency procedures, costs associated with distributing the safe custody assets or client money are usually borne by the owners of those assets/monies. The FCA considers this to be detrimental to the interests of a firm's client base as a whole as it leads to an overall delay or reduction in the amount of assets and monies that would otherwise be available for distribution to clients.

41. **Provision D - Requirements on firms who wish to dispose of safe custody assets which have been unclaimed by clients** - Firms currently have limited choice and are uncertain how to handle holdings of unclaimed custody assets where clients have, in effect, disclaimed these assets. For some firms, continuing safeguarding and administering custody assets, where the clients are no longer traceable, can be costly and burdensome, particularly where the firms wish to cancel their permissions in relation to that activity. This creates inefficiencies for firms.

Explanation of why the Provisions are proportionate

42. **Provision A – Disclosure of information to retail and non-retail clients relating to client money and safe custody asset arrangements** – we consider that a proportionate way to address the misconceptions or lack of understanding across all clients (as set out in paragraph 38) is to ensure that all clients are given the same information by extending the disclosure requirements that are applicable to retail clients, to all client types. This is reinforced by respondents who in consultation noted that they consider it necessary to, and already do, provide the same information to all client types.

43. We also consulted on addressing this lack of understanding through the introduction of a requirement for firms to provide

clients with a stand-alone disclosure document summarising the key provisions in clients' agreements which modified rights or protections which would otherwise be available to clients under the safe custody rules or the client money rules. Given the fact that some clients would already have the same information set out in their client agreements and the costs associated with this, we concluded that the extension of the existing disclosure requirements to all clients was more proportionate.

44. **Provision B - Written agreements between a firm and any third party with whom it deposits safe custody assets** – While as a result of this change the safe custody asset rules will explicitly require firms to put these written agreements in place, this is proportionate as we expect that the vast majority of these arrangements will have written agreements already in place. This is supported by industry feedback to our consultation stating that this is a sensible approach and an understanding that many firms already have such agreements in place.

45. **Provision C - Procedures for the termination of title transfer collateral arrangements –** This is proportionate as we are not limiting the contractual freedom between clients and firms to enter into title transfer collateral arrangements, but merely imposing a structured procedure and record keeping requirements for firms to follow where clients wish to transfer into safe custody asset or client money rule protections to ensure that in the event of a firm failure there is clarity as to which safe custody assets and client money form part of the client asset etsate and which money or assets form part of the general estate.

46. **Provision D - The ability for firms to dispose of safe custody assets which have been unclaimed by clients** – We have been asked by firms how they should treat safe custody assets that remain unclaimed by clients that the firms are unable to contact. In order to ensure that these firms are not required by our regime to bear the costs and burden of safeguarding such assets indefinitely when they have effectively been abandoned, it is proportionate to introduce this Provision. Firms are not required to dispose of unclaimed assets in this way but may do so if they wish following a prescriptive procedure to ensure that clients are given reasonable opportunity to claim the assets.

47. We have attached a high level costs benefit analysis relating to the Provisions at Annex 1 following a pre-consultation survey of a representative sample of firms. Further details of this analysis are available on request.

Explanation of why the Provisions do not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive

48. The Provisions will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive. This is because the FCA will not apply them to firms exercising rights under Articles 31 or 32.

ANNEX 1: High Level Cost Benefit Analysis

1. In the consultation paper[4] we published in July 2013 we set out a detailed cost benefit analysis (CBA) of the proposals the subject of the consultation, including the proposals leading to the final Provisions. This Annex sets out some extracts from that CBA that are most relevant to the Provisions.

Main Market Failures

2. **Customers placing client money and assets with investment firms cannot assess the associated risks (asymmetric information)** - While it may be in clients' interests to monitor firms to ensure sufficient protection of client assets, monitoring costs may prevent them from doing so. Clients may not be fully aware of how their client assets placed with an investment firm are being used or whether their funds are being adequately segregated and accurately recorded. As such they cannot assess the risks they would be exposed to in the event of firm failure (for example significant delays in the return of client money/assets or shortfalls). This is particularly the case for retail clients who will have limited time, knowledge or bargaining power when placing client assets with firms. Similar risks exist for non-retail clients.

3. Although non-retail clients have more expertise, resources and bargaining power to ensure their funds are adequately protected, there is evidence that non-retail clients that transfer assets on a title transfer collateral basis or have their assets re-hypothecated (and therefore, having lost client asset protection over the asset) receive higher levels of return when placing their assets at a firm. Anecdotal evidence from several high-profile firm failures suggests that some non-retail clients were not aware they by transferring full title to their assets to the firm, the client had lost client assets protection. However, more recent evidence suggests that non-retail clients are currently paying significantly more attention to CASS protections, making more informed choices regarding their decision to waive these protections. This behaviour may not continue as the impact from recent firm failures fades.

[4] Pages 69-86, http://www.fca.org.uk/static/documents/consultation-papers/cp13-05.pdf

4. **Reputation and brand no longer a relevant factor for firms** - In most well-functioning markets, the reputation of particular firms and brands plays an important role in signalling quality and price information to consumers. This helps to discipline firms to provide good service and develop good value products. In the absence of regulation, and where we are considering the quality of client asset protections in the event of firm failure, the firm has no incentive to maintain a good reputation. Failure of the firm by its definition means that the firm will most likely exit the market and that the fact it has not kept adequate client asset records does not alter its future reputation or profitability. This creates a similar competitive dynamic as when consumers do not pay attention to CASS protections – that is firms do not compete on the basis of client asset protection and therefore have no incentive to improve or even maintain standards.

5. **Delays in the return of clients' asset or shortfalls in the asset returned can, if significant, cause market instability (negative externality of poor client money protections)** - Information and behavioural problems can lead to inadequate client assets protections, that in turn lead to delays and shortfalls in client assets returned to individual consumers. Inadequacies can lead to litigation by clients for their share of the client assets, leading to higher distribution costs and therefore higher shortfalls in returns to clients. At the macro level, delays and shortfalls for non-retail clients can have significant implications for market stability and the wider economy. The size of the market stability impact depends on the size, composition of the customer base (non-retail versus retail) and systemic importance of the failed institution. Having good record keeping can reduce the wider negative impact of firm failure.

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6. **Provision A – Disclosure of information to retail and non-retail clients relating to client money and safe custody asset arrangements** - The proposal to remove the client distinction for existing information requirements requires firms to provide the same information to all types of clients (in addition to retail clients as currently required). Half of CASS Large firms[5] reported one-off

[5] CASS firm types are determined by the highest total amount of client money and highest total value of safe custody assets a firm held in the previous calendar year. See CASS 1A.2.7R.

costs (highest £1.3m and median of £2,000). Approximately 30% of CASS Medium firms reported one-off costs with these proposals (highest £30,000 and a median of less than £1,000). Approximately 70% of small firms estimate costs arising from these proposals (highest £20,000 and median of less than £4,000). The on-going costs vary significantly, but the median for all categories of CASS firms is estimated to be less than £6,000.

7. **Provision B - Written agreements between a firm and any third party with whom it deposits safe custody assets -** The requirement for written custody agreements codifies an existing expectation that firms would have in place adequate records in relation to their arrangements with sub-custodians. The majority of survey respondents (95%) identified no additional costs associated with this rule.

8. **Provision C - Procedures for the termination of title transfer collateral arrangements -** The majority of respondents to the survey did not identify one-off or ongoing compliance costs associated with the requirements surrounding the termination of title transfer collateral arrangements.

9. **Provision D - The ability for firms to dispose of safe custody assets which have been unclaimed by clients** - The rules providing firms with a method to cease to treat unclaimed assets as safe custody assets will allow firms to potentially reduce the ongoing burden they have of being required to comply with the custody rules in relation to assets they have held for a long period of time that have remained unclaimed. We are therefore of the opinion that there will not be material costs associated with this proposal.