Recommendations Regarding the Protection of Client Assets

Consultation Report

THE BOARD
OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

CR02/13 **FEBRUARY 2013**

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Foreword

The International Organization of Securities Commissions' (IOSCO) Board has published this Consultation Report with the aim of outlining principles against which both the industry and regulators can assess the quality of regulation and industry practices concerning client asset protection. Generally, these draft principles reflect a level of common approach and are a practical guide for regulators and the industry. Implementation of the principles may vary from jurisdiction to jurisdiction depending on local conditions and circumstances.

How to Submit Comments

Comments may be submitted by one of the two following methods **before Monday 25 March COB CET.** To help us process and review your comments more efficiently, please use only one method.

Important: All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

1. Email

- Send comments to clientassetprotection@iosco.org **cc. m.bensalem@iosco.org**
- The subject line of your message must indicate ***client asset protection***
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc) to create the attachment.
- Do NOT submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

2. Paper

Send 3 copies of your paper comment letter to:

Mohamed Ben Salem
General Secretariat
International Organization of Securities Commissions (IOSCO)
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28006 Madrid
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Your comment letter should indicate prominently that it is in relation to the Consultation Report on Client Asset Protection.

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Introduction

Events in recent years including the Lehman Brothers and MF Global insolvencies have placed client asset protection regimes in the spotlight, as investors have tried to better understand the potential implications of placing their assets with particular intermediaries and in certain jurisdictions. Regulators have sought to address risks to client assets and determine how to transfer or return client assets in default, resolution or insolvency scenarios. These concerns have led some regulators to consider how they might enhance their supervision of intermediaries holding client assets through clarification of the respective roles of the intermediary and the regulator in protecting client assets.

While client asset protection regimes may vary across jurisdictions, many jurisdictions have rules and regulations governing client assets. It is first and foremost the intermediary's responsibility to ensure compliance with these rules, including through the development of internal systems and controls to monitor compliance. Where the intermediary places client assets with third parties, the intermediary should reconcile its accounts and records with those of the third party. While the intermediary must comply with the client asset protection regimes, the regulator has a role in supervising the intermediary's compliance with the applicable domestic rules and maintaining a regime that promotes effective safeguarding of client assets.

Two possible scenarios may pose regulatory challenges: where a client has knowingly or unknowingly waived or modified the degree of protection applicable to client assets or otherwise opted out of the application of the client asset protection regime (where permitted by law); and where an intermediary has placed or deposited assets in a foreign jurisdiction.[1]

To address the former issue, and to provide greater clarity regarding the status of client assets, documentary requirements should apply. The intermediary should be required to obtain the client's explicit, written consent to any waiver or modification to protection of the client asset regime or to any opting out of the client asset protection regime. Where such a waiver, modification or opt-out is permitted by law, any client consent should be set forth in a separate document that addresses only the provision of the consent. The consent should be affirmative and explicit and should not be "deemed" or "implied". It is important that clients are aware of the possible effects of a waiver or modification of the degree of protection applicable to client assets or opt-out of the application of the client asset protection regime, especially in the context of a default, resolution or insolvency scenario. In addition, the documentation could help clarify the status of client assets at a particular point in time and, if necessary, facilitate return of any client assets in a default, resolution or insolvency scenario.

Where an intermediary has placed or deposited assets in a foreign jurisdiction, the regulator may face further challenges in supervising the intermediary's compliance with the applicable domestic rules. Additional challenges may arise if an intermediary holds client assets in a chain of custody through multiple jurisdictions or places assets with an affiliate in the same group or with a third party regulated, in either case, and if at all, outside the intermediary's home jurisdiction. Where the domestic regulatory

[1] With respect to an intermediary whose home jurisdiction is an EU member state, references in this report to placing or depositing client assets in a *foreign jurisdiction* should be read as meaning placing or depositing client assets in a jurisdiction outside of the EU.

regime prescribes requirements for client assets placed in foreign jurisdictions, the regulator should consider how to accomplish its supervisory responsibilities.

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The terms used in the Principles are defined in the Glossary at the end of the report. .

Principles

Principle 1 – An intermediary should maintain accurate and up-to-date records and accounts of client assets that readily establish the precise nature, amount, location and ownership status of client assets and the clients for whom the client assets are held. The records should also be maintained in such a way that they may be used as an audit trail.

Means of implementation

1. An intermediary should establish systems and controls for maintaining accurate and up-to-date records of client asset holdings including information specifying the amount, location, and ownership status[2] of client assets.
2. The intermediary's records should be sufficient to permit an external party (such as a regulator, an external auditor, or an insolvency practitioner) to verify the amount, location, ownership status and identity of assets held. Where client assets are held with a third party, records should also include the location and the terms and conditions on which a third party holds the client assets.
3. The intermediary's systems and controls should provide for reconciliations on a regular basis between internal accounts and records in relation to the client assets and those of any third party with whom such client assets are held. In the context of reconciliations between an intermediary and a central securities depository, such reconciliations should take place on a daily basis.
4. The records and accounts should enable an intermediary to, at any time and without delay, specify each client's rights and the intermediary's obligations to each client with respect to client assets.
5. In those jurisdictions where clients may waive, consent to the modification of, or otherwise opt out of any aspect of client asset protection, the intermediary should maintain sufficient records to clearly demonstrate, as applicable, the client's explicit, written and informed consent to the waiver or modification of the protection of client assets or to opting out of the client asset protection regime.
6. Accounts held with a third party for the benefit of clients should be titled in such a way to clearly distinguish assets held for clients from assets held for the intermediary. Where separate accounts at a third party are held for each client, the accounts should be titled in such a way as to clearly distinguish assets held for one client from assets held for any other client or for the intermediary itself.

[2] An example of ownership status is the existence of liens or other encumbrances that may affect the return of client assets or their value to clients.

Principle 2 – An intermediary should provide a statement to each client on a regular basis, as well as on request, detailing the client assets held for or on behalf of such client.

Means of implementation

1. The statement the intermediary provides should be a statement of account or other report to clients showing their asset holdings and money balances as of a reasonably recent date.
2. Where, to the extent permitted by law, the client has waived or modified any aspect of the client asset protection regime, or otherwise opted out of the application of the client asset protection regime, the statement should reflect that fact.
3. Where a client has requested a statement from an intermediary in relation to its assets, the intermediary should respond reasonably promptly to the request.

Principle 3 – An intermediary should maintain appropriate arrangements to safeguard the clients' rights in client assets and minimise the risk of loss and misuse.[3]

Means of implementation

1. An intermediary should understand the options, if any, for holding client assets and take into account the levels of client asset protection (both pre- and post-default) in addition to any associated risks.
2. An intermediary should also analyse how certain actions or decisions could materially change the status of the client asset and/or complicate return of the client asset (*e.g.*, if the exercise of a right of re-use or enforcement of a pledge results in a different party succeeding to rights in the client asset). An intermediary may build this understanding through in-house analysis as well as through consultation with professional advisors (*i.e.*, law firms or accountancy firms).
3. Where client assets are placed with a third party (whether in the same jurisdiction or in a foreign jurisdiction), the intermediary should exercise all due skill, care and diligence in the selection and appointment (where applicable), and periodic review of the third party and of the arrangements for safeguarding the client assets, and should consider:
   (a) The legal requirements or market practices related to the holding of client assets that could adversely affect clients' rights during business as usual and in the event of resolution or insolvency of the intermediary or the third party;
   (b) The expertise and market reputation of the third party;
   (c) Protection or lack thereof attendant upon the regulatory status of the third party; and
   (d) The need for diversification and mitigation of risks, where appropriate, by placing client assets with more than one third party.
4. Where an intermediary places client assets with a third party, the intermediary should, to the extent necessary to achieve compliance with applicable domestic requirements, understand the material effects of the contractual provisions governing that arrangement on the clients' rights in respect of such client assets, including how those contractual provisions would operate in the

[3] As noted above, these Principles apply to cases where an intermediary has responsibility for safeguarding client assets as opposed to cases where an intermediary does not have responsibility for safeguarding client assets.

jurisdiction where such assets are held, including in the event of the resolution or insolvency of the intermediary, the third party or both.

5. An intermediary should be aware of the effect of liens and other encumbrances on client assets and take appropriate steps to ensure that any such lien or encumbrance is only granted to the extent, if any, permitted by the regulatory regime, including with respect to any requirement for client consent.[4] Each intermediary should consider the best interest of the clients[5] to the extent it has a choice in agreeing to liens or encumbrances.

Principle 4 – Where an intermediary places or deposits client assets in a foreign jurisdiction, the intermediary should understand and take into account the foreign regime to the extent necessary to achieve compliance with applicable domestic requirements.

Means of implementation

To the extent the home regime imposes requirements on an intermediary that places or deposits client assets in a foreign jurisdiction, the intermediary may face challenges in ensuring its compliance with such domestic requirements. Accordingly, the intermediary should have sufficient knowledge of the domestic as well as foreign regimes where it places client assets to the extent necessary to ensure such compliance. This means that the intermediary has the responsibility to understand the client asset protection regimes and arrangements in every jurisdiction (including its home jurisdiction) in which client assets are kept, to the extent necessary to ensure compliance with the domestic requirements.

Principle 5 – An intermediary should ensure that there is clarity and transparency in the disclosure of the relevant client asset protection regime(s) and arrangements and the consequent risks involved.

Means of implementation

1. Consistent with the requirements of its home jurisdiction, an intermediary should ensure its agreements with clients contain adequate and appropriate information about the arrangements for client asset protection and the ways in which the intermediary holds or deposits different types of client assets and the attendant risks. These disclosures should (i) be appropriate in light of the relationship between the client asset and the client's rights in the asset and (ii) take account of the fact that the ownership status of the client assets may affect the degree of protection.
2. Where client assets are to be held in a foreign jurisdiction and will be subject to the client asset protection and/or insolvency regimes of that foreign (*i.e.*, not home) jurisdiction, the intermediary should inform the clients of that fact and highlight material differences and the

[4] See Principle 6.

[5] The phrase "best interest of the clients" should not be interpreted to suggest the application of a fiduciary standard beyond the extent required by a relevant jurisdiction. In some common law jurisdictions, certain intermediaries may be subject to the duty to act fairly, honestly and in good faith, while not being technically subject to a fiduciary standard of care.

potential consequences of such differences so the client can make an informed decision concerning its investment.

3. Any required disclosure should be in writing and be prepared in clear, plain, concise and understandable language. Legal or financial jargon not commonly understood should be avoided.
4. Where the intermediary has determined there are material risks of placing client assets in a particular foreign jurisdiction and where those risks cannot be effectively mitigated by the intermediary, the intermediary should clearly and understandably disclose those risks in advance to the clients so that such clients can make informed decisions concerning their investments.

Principle 6 – Where the regulatory regime permits clients to waive or to modify the degree of protection applicable to client assets or otherwise to opt out of the application of the client asset protection regime, such arrangements should be subject to the following safeguards:

(a) The arrangement should only take place with the client's explicit, written consent.

(b) Before such consent is obtained, the intermediary should ensure that the client has been provided with a clear and understandable disclosure of the implications of giving such consent.

(c) If such arrangements are limited to particular categories of clients, clear criteria delineating those clients that fall within such categories should be defined.

Means of implementation

1. Any (a) waiver or modification of any aspect of the client asset protection regime or (b) any opting out of the client asset protection regime should, in either event, be contained in a separate document and be clear and in writing, through whatever technical means, and affirmatively executed by the client.
2. The writing evidencing the client's consent to the waiver or modification of the protection of client assets or to opting out of the client asset protection regime should effectively communicate to the client the effect of a waiver, modification or opt-out both pre- and post-default. The written client's consent should be retained by the intermediary and should allow the intermediary to demonstrate clearly what the client agreed to and the client's confirmation of its understanding of the implications of giving consent. This documentation may help clarify the status of client assets at a particular point in time and, if necessary, facilitate the return of any client assets in a default, resolution or insolvency scenario.
3. To ensure informed consent from the client in relation to a waiver or modification of the protection of client assets or to an opt out of the application of the client asset protection regime, the separate client consent document should contain adequate and appropriate information and, where appropriate, relevant risk disclosures about:
   (a) The contractual and/or statutory limits, if any, on different types of client assets in respect of which the waiver, modification or opt-out is agreed and a clear explanation of how the limits are calculated;
   (b) The consequences to the client of such waiver or modification of the protection of client assets or of such opt-out of the application of the client asset protection regime, and the effect on the client's rights of any exercise of such waiver, modification or opt-out by the intermediary in the ordinary course of business or in the event of a third party's or

intermediary's insolvency, and the nature and extent of risks associated with each waiver, modification or opt out, and any investor compensation scheme, where applicable. This should include material risks to the client of having any client assets held in foreign jurisdictions; and

(c) The client's right to call for redelivery of the assets, where applicable.

4. If a waiver, modification or opt-out of client asset protection is permitted in a jurisdiction, the regulatory regime of that jurisdiction should define criteria to delineate the qualifications of clients who will be permitted to waive or modify the protection applicable to client assets or otherwise to opt out of the client asset protection regime. Any such criteria should be clear. Such jurisdictions should also consider prohibiting specific classes of clients from waiving or modifying the protection applicable to client assets or from opting out of the client asset protection regime where that class of client is judged unlikely to have the knowledge or ability necessary to assess effectively the risks associated with the waiver, modification or opt-out.
5. Where appropriate, regulatory regimes may consider requiring different levels of disclosure by an intermediary of the consequences of any waiver, modification or opt-out for different types of clients that are commensurate with their respective sophistication and knowledge of financial markets.

Principle 7 – Regulators should oversee intermediaries' compliance with the applicable domestic requirements to safeguard client assets.

Means of implementation

1. Regulators should have and use adequate tools to effectively monitor an intermediary's compliance with the domestic client asset protection regime. Such tools may include, among other things, regulatory measures such as:
   (a) Mandatory reports to the regulator from an intermediary, whether sent on a periodic basis or upon the occurrence of specific events, as to the amount, location, value and ownership status of client assets held, the status of the intermediary's compliance with the applicable requirements and any separate client asset protections that apply where client assets are invested;
   (b) Mandatory periodic or occurrence-related reports to the regulator from self-regulatory organizations (where applicable) as to the status of the intermediary's compliance with the applicable requirements;
   (c) Mandatory reports sent to the regulator from independent external auditors, provided at least annually, as to the adequacy of the intermediary's arrangements in safeguarding client assets;
   (d) Ad-hoc inspection visits to assess the adequacy of the intermediary's arrangements in safeguarding client assets; and
   (e) The establishment of *whistle-blowing* programs to provide an additional mechanism for the monitoring of an intermediary's compliance.
2. The regulator may decide to use a risk-based approach to supervise its intermediaries' compliance with the applicable domestic client asset protection requirements. Such a risk-based analysis should focus on intermediaries that pose the greatest regulatory concerns and should, where practicable, consider:

(a) The value of client assets held by the intermediary (as an indication of the impact the insolvency of the intermediary would have on clients and the market);
(b) The location of the client assets (as an indication of the impact of concentration risk on that particular intermediary or third party);
(c) The prudential/capital health of the intermediary (as an indication of the likelihood of the insolvency of the intermediary); and
(d) The status of the intermediary's general governance, systems and control arrangements, regulatory history and complexity of its business (as an indication of potential internal compliance risk posed by the intermediary).

3. The factors referred to in 2 above may also influence the depth of the analysis the regulator conducts with respect to a particular intermediary.
4. Where a jurisdiction requires intermediaries to meet specific qualifications in order to be considered eligible to place or deposit client assets in foreign jurisdictions, the regulatory regime should define clear criteria to delineate those qualifications.

Principle 8 – Where an intermediary places or deposits client assets in a foreign jurisdiction, the regulator should, to the extent necessary to perform its supervisory responsibilities concerning applicable domestic requirements, consider information sources that may be available to it, including information provided to it by the intermediaries it regulates and/or assistance from local regulators in the foreign jurisdiction.

Means of implementation

1. Regulators should use available information sources in performing their supervisory responsibilities with respect to intermediaries placing or depositing client assets in foreign jurisdictions.
2. Intermediaries
   (a) Where the regulator has the power to require this, it may obtain from an intermediary information on the operation of the client asset regime in the foreign jurisdiction (or, where relevant, jurisdictions) where the intermediary places or deposits client assets, and may require such intermediary to demonstrate that it has complied with any applicable client communication requirements.
   (b) Where a regulator has the power to request information regarding the amount, location, value and ownership status of client assets, it should request such information from regulated intermediaries to the extent necessary to perform its supervisory responsibilities.
3. Cooperation with other regulators
   (a) Regulators should endeavour to respond to requests from foreign regulators regarding their client asset protection regime and/or insolvency regime, as far as the request falls within their remit. The local regulator may be in a better position to outline the standards in its jurisdiction and to explain how the client asset protection regime works generally as well as in default scenarios.
   (b) Regulators should consider seeking assistance from the local regulator to obtain information concerning how the foreign client asset protection regime operates. The

local regulator may have access to better information and records than the home regulator and, in some cases, may be able to verify the location of client assets (*e.g.*, where permitted by applicable law or regulation, by cross-checking records or through on-site inspections).

(c) Regulators should also consider whether there are adequate mechanisms in place to promote information sharing between jurisdictions whether through pre-existing workstreams (*e.g.*, the IOSCO survey on client asset protection regimes) or in response to ad hoc requests from individual regulators. In particular, regulators should consider whether existing memoranda of understanding (MOUs) are sufficient to provide for information sharing or whether further MOUs or side letters are required.

(d) Regulators should consider any confidentiality and/or data protection issues that may prevent information sharing (especially in a cross-border context). Regulators should consider whether existing MOUs (including side letters) cover, or new memoranda of understanding should be agreed to address confidentiality or other concerns.

(e) To the extent consistent with any confidentiality and/or data protection rules, the regulator should be able to share information with respect to a particular intermediary or particular client asset as necessary. This could include, where permitted by applicable law or regulation, verifying the existence of particular assets or the holdings of a particular intermediary if necessary (*e.g.*, through an on-site inspection or by cross-checking records) and/or sharing information about the intermediary's record of compliance with client asset protection rules.

(f)

Glossary

Client asset protection regime – the statutes, regulations, rules or other legally binding requirements of a jurisdiction (including, where applicable, of a self-regulatory organisation) in relation to protection of client assets and any associated rights.

Client assets – assets (or an analogous term) in respect of which the intermediary has an obligation (either contractual or regulatory) to safeguard for its clients, including, to the extent appropriate, client positions, client securities and money (including margin money) held by an intermediary for and on behalf of a client.

Client positions – contractual rights arising from transactions entered into by an intermediary on behalf of its clients, including mark to market accruals arising from the change in value of futures and options positions.

Client securities – securities, bonds, notes, shares and other similar instruments held for or on behalf of a client, including fully paid securities and margin securities.

Fully paid securities – securities for which a client has fully paid, and which are free from further pledges and encumbrances.

Intermediary – a securities firm (including a derivatives firm) that is subject to supervision by a regulatory authority.

Margin securities – securities purchased in part with money a customer has borrowed from the intermediary.

Regulators – regulatory authority responsible for the supervision of intermediaries' compliance with the applicable client asset protection regime including, where applicable, self-regulatory organisations acting in a supervisory capacity.

Third party – a party with whom client assets are placed by the intermediary (such as a bank, central counterparty or other entity).