CLIENT ASSET PROTECTION

REPORT OF THE

IOSCO TECHNICAL COMMITTEE

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CONTENTS

EXECUTIVE SUMMARY

The protection of assets held by customers at authorised firms from the risk of loss, whether arising from misuse or from the insolvency of the firm is a central objective of any system of investor protection. In this paper, the Technical Committee sets out an analysis of the main techniques which securities regulators can use in order to achieve a satisfactory level of client asset protection, and makes a number of recommendations to regulators about the characteristics of such regimes.

For the purpose of this paper, client assets are defined as money, securities and positions which are held or controlled by authorised investment firms for investment purposes on behalf of their customers. In order for markets to operate effectively, it is unavoidable that authorised firms should hold or control client assets when undertaking investment business on their behalf. Consequently, it is of great importance to investor protection and to confidence in markets that customers should know that their assets will be protected so far as practicable from the risk of loss at the authorised firm which holds those assets.

Section 1 of the paper outlines the basic objectives of any system of client asset protection. It recognises that there are a number of risks to client assets, but notes that these become particularly acute in the event of the insolvency of an authorised firm which holds client assets. It also recognises that a system of client asset protection will inevitably need to be adapted to the particular legal and regulatory framework of each jurisdiction, and will need to take into account the cost implications of such measures. It notes the role of transparency in making clear to clients the protection arrangements that apply to their assets, and the preventative role played by effective internal controls at authorised firms and by regulatory supervision arrangements for authorised firms which hold client assets.

Section 2 of the paper outlines the techniques which can be used to protect clients assets in the event of the insolvency of an authorised firm and discusses the advantages and disadvantages of such techniques. It analyses three types of technique:

A techniques which seek to ensure that client assets are treated in a more favourable way than the other obligations of a firm in the event of insolvency;

A techniques which aim to compensate clients of insolvent firms; and

A techniques which customers themselves can use to minimise their exposure to authorised firms.

Particular techniques which are discussed in this section include according client assets preferential status in insolvency law; arrangements whereby client assets are kept separate at all times from the assets of the authorised firm; the securitisation of money through the use of money funds; compensation schemes; and the use of commercial insurance arrangements such as professional indemnity insurance. The paper notes that there are merits to all such techniques, but none is without disadvantages.

Section 3 identifies a number of issues relating to client asset protection generally and recommends the appropriate regulatory response. Issues addressed in this section include considerations related to the selection of custodians; the particular risks for client asset protection regimes when dealing takes place through a chain of related parties; issues associated with cross border dealing and differing levels of client asset protection in different jurisdictions; consideration of the risks associated with the use of omnibus accounts; and arrangements for opting out of client asset protection regimes.

Section 4 then considers issues specifically related to the protection of client money, securities and positions respectively. This includes the protection of client money where banks act as brokers; the regulatory status of custody as an activity; the risks associated with stock lending; the treatment of clients= securities in the course of settlement; the legal status of client positions at authorised firms where the firm is acting as agent for the customer; arrangements to facilitate the transfer of client positions from insolvent firms; and the need for effective identification and segregation of client margin.

In the course of the analysis in the paper, the Technical Committee makes the following twenty recommendations for use by securities regulators when considering client asset protection regimes.

Recommendation 1:

Regulatory authorities should recognise the benefits for investor protection and confidence in financial markets of effective mechanisms to protect client assets from the risk of loss and the insolvency of investment firms.

Recommendation 2:

Regulatory authorities should choose within their jurisdictions those mechanisms which best achieve the overall objective of client asset protection, taking into account their national insolvency and investment services laws, regulations and practices; the needs of market efficiency and investor protection; and the costs of any such measures.

Recommendation 3:

Regulatory authorities should seek to ensure that investors are adequately informed about the arrangements for client asset protection within their jurisdictions. In particular, they should require that authorised firms report on a regular basis to their clients as to the assets which they hold on their behalf, and to make appropriate disclosure to clients about the way in which client assets which the firm holds are protected within their jurisdiction. Where client assets are to be held in another jurisdiction, and different client protection arrangements apply to those assets, the firm should be required to inform the client of that fact.

Recommendation 4:

Regulatory authorities and authorised firms should recognise that effective internal controls for identifying, accounting for and safeguarding client assets are essential prerequisites for effective client asset protection.

Recommendation 5:

Regulatory authorities should:

i) recognise the need for appropriately intensive supervision of firms that hold or control client assets; and

ii) review the techniques and powers of intervention available to regulators or other relevant authorities both before and after the default of a firm which holds client assets.

Recommendation 6:

Regulatory authorities which require the use of third parties to hold client assets should, where appropriate to their client asset protection regimes, set criteria for the selection of such custodians with the objective that the level of protection enjoyed by clients should be maintained, if not enhanced, and the nature of any risks adequately disclosed.

Recommendation 7:

Regulatory authorities should carefully consider the circumstances in which authorised firms may be permitted to meet the requirements of a client asset protection regime by holding client assets with a related custodian. Where they are, there should be clearly defined criteria for the practice of selecting those related third parties. These should include clear disclosure of any different risks to clients, particularly the implications, if any, for compensation schemes.

Recommendation 8:

Regulatory authorities should as far as possible decide on and clarify the extent to which investment firms should accept responsibility for the choice and conduct of banks and custodians which hold client assets on their behalf and the extent to which the client will be liable on the default of that third party. If responsibility is not accepted by the investment firm, that fact should be made clear in client documentation.

Recommendation 9:

Regulatory authorities should ensure that, where a firm deals with an unrelated firm within their jurisdiction, client assets are identified as such to that third party and equivalent protection is afforded to any such assets.

Recommendation 10:

Regulatory authorities should ensure as far as practicable that where an investment firm deals through a chain of related parties within its jurisdiction client assets are separately identified from the proprietary assets of the group, and client asset protection arrangements available at the initial point of dealing are preserved throughout the chain.

Recommendation 11:

Regulatory authorities should:

i) ***consider extending client asset protection within their own jurisdiction to assets received by investment firms which are classified as client assets in the jurisdiction of the firm from which the assets are received; and***

ii) ***should require that client assets are identified as such and appropriate protection is requested for them by firms in their jurisdiction when these assets are passed to firms in other jurisdictions.***

Recommendation 12:

Regulatory authorities should consider measures to ensure that the use of omnibus accounts does not unduly prejudice the overall objectives of client asset protection within their jurisdictions. Investors should be made aware of the risks inherent in the use by authorised firms of omnibus accounts.

Recommendation 13:

Where regulatory authorities permit opting out of client asset protection, they should establish clear criteria under which particular classes of investors are able to do so and ensure that any material consequences of so doing are made clear to those investors.

Recommendation 14:

Regulatory authorities should ensure that when a bank passes clients' money to a third party in the course of undertaking investment business on behalf of clients,

it separately identifies the funds as relating to dealings on behalf of clients; and

to the extent possible it seeks client asset protection from the third party to whom such monies are sent.

Recommendation 15:

Regulatory authorities should review the regulatory and supervisory arrangements for custody in their jurisdictions.

Recommendation 16:

Regulatory authorities should ensure that regulations provide for:

i) ***the prior authorisation by customers of securities lending activity;***

ii) clarity as to who is assuming the risks in securities lending transactions;

iii) the need for clear, industry standard documentation; and

iv) adequate regulation and appropriate supervision of securities lending activity.

Recommendation 17:

Regulatory authorities should review the adequacy of arrangements within their jurisdiction for ensuring that client securities in the course of settlement are not unnecessarily mixed with those belonging to the investment firm.

Recommendation 18:

Regulatory authorities should ensure that there is clarity as to the arrangements for protecting client positions held as a result of transactions entered into in their jurisdictions.

Recommendation 19:

Within each jurisdiction, to the extent possible, the regulatory regime should facilitate the transfer of positions from firms including related party firms which have become insolvent. Arrangements at clearing houses should be consistent with the objective of client asset protection at authorised firms and in particular have arrangements which permit the separate identification of client and proprietary positions.

Recommendation 20:

Regulatory authorities should ensure that the provision of margin is the subject of clear, written agreements between the firm and its clients and that the firm should operate appropriate internal controls to ensure that margin posted for client positions is properly accounted for and segregated on behalf of such clients.

INTRODUCTION

DEFINITIONS

1. In this paper, the following terms are used in the way described:

AAuthorized firm≅, **Ainvestment firm≅** and **Afirm≅** means a firm whose investment business activities fall under the authority of a jurisdiction's regulator of investment firms. It includes banks as well as traditional investment firms in jurisdictions where some or all of a bank's investment business is regulated through the relevant investment services law of the jurisdiction.[1]

ACustomers≅ and **Aclients≅** mean persons or other entities on whose behalf authorised firms hold assets in connection with investment services business. The precise definition of customer or client varies from one jurisdiction to another. This paper is not directly concerned with the scope of the definition of client or customer as much as the consequences of being one.

2. The **Aclient assets≅** with which this paper is concerned fall into three major categories:

A **client money**, which is money owed to or held on behalf of clients by an investment firm, and may include income relating to an investment such as dividends or interest;

A **client securities** which are often represented by a certificate, but are increasingly held in a Adematerialised≅ or book entry form; and

A **client positions** which are contractual rights arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures and options positions.

These three classes of asset are collectively referred to as Aclient assets≅.

[1] For the purposes of this paper, investment services includes securities, commodities and derivatives business.

SECTION 1 GENERAL PRINCIPLES

WHY PROTECTION OF CLIENT ASSETS IS IMPORTANT

3. Clients are dependent on investment firms to conduct a range of activities on their behalf. Authorised firms hold and control client assets, transfer client assets and may use one type of asset (for example, cash) to acquire another (for example, securities) in the course of providing client asset protection. It is, therefore, critical to the confidence of customers and the markets generally that these assets should be safe when they are held or controlled by an investment firm.

4. In addition to the investor protection concern of taking reasonable steps to avoid loss to clients, if the public lack confidence in the client protection mechanisms, then inefficiencies in the respective markets may arise. Clients may incur additional costs and time to ensure that they can negate or minimise the effects of the insolvency of an investment firm that operates in the market on their behalf. Alternatively, clients may determine not to participate in the market if they consider that the risk of loss of their assets as a result of the fraud, carelessness, unclear responsibilities or insolvency of investment firms is too high.

5. The ultimate objective of client asset protection is to enhance investor protection and public confidence in financial markets. This objective is achieved by the public having confidence that, as far as possible, their assets will be properly handled and accounted for and that they will not be adversely affected by the insolvency of firms which control assets on their behalf.

The Relevance of Insolvency

6. There are a number of ways in which client assets can be endangered. These include fraud or misappropriation by the firm or its employees, and inadequate controls and accounting procedures at authorised firms. Many of the techniques discussed in this paper are useful in reducing these risks. However, while important in themselves, the risk to the customer becomes most acute when the firm is not in a position to compensate clients for losses because of its own insolvency. The principal focus of this paper is therefore on the insolvency of the investment firm to which the customer entrusts its assets.

7. Where an investment firm becomes insolvent, there is potential for conflict between those who have an interest in maximising the value of the firm's assets available generally to creditors and those whose assets are held or controlled by the firm. Client asset protection regimes endeavour to resolve some of these conflicting claims by ensuring that, as far as possible, client assets held by authorised firms are not exposed to the insolvency of those firms.

8. It should, however, be noted that the insolvency of other firms within a chain of relationships may also prejudice the safety of customer assets. This may arise because

the firm does not accept full responsibility for assets held with third parties, or because the insolvency of that other firm threatens the solvency of the firm itself.

9. Insolvency law generally reflects two basic premises - the maximisation of the value of the insolvent firm and an appropriate allocation of the realisation of assets between those affected by the insolvency. The way in which these basic premises are reflected in national legislation can vary substantially. It is important to recognise the role played in this respect by public policy and to recognise that, as a result of differing policy, the scope and techniques of client asset protection might vary from jurisdiction to jurisdiction.

Recommendation 1:

Regulatory authorities should recognise the benefits for investor protection and confidence in financial markets of effective mechanisms to protect client assets from the risk of loss and the insolvency of investment firms.

A VARIETY OF MECHANISMS

10. It is important to note that effective client asset protection can be achieved in a number of ways, often through a combination of methods. The specific methods to be used may vary considerably from jurisdiction to jurisdiction, reflecting different market traditions, political influences and legal and regulatory systems. In particular, variations in client asset protection regimes might arise from differing approaches to:

A the public policy underlying a jurisdiction=s insolvency law;

A the relative importance given to the protection of individual investors or to overall market integrity;

A differing legal concepts, such as the existence of trust law; or

A different requirements for members of organised markets.

11. One aspect of public policy which may differ between jurisdictions is whether the concern within financial markets is to protect the investor or to protect the integrity and efficiency of markets by ensuring the smooth operation of settlement and payment systems. In many markets, both are important, and the two ends do not need to be seen as mutually exclusive in the ability of authorities to achieve them. The balance of emphasis between these two objectives can, however, affect the approach to client asset protection adopted in particular markets.

12. Cultural and public policy differences might make the framing of minimum, global standards for client asset protection more difficult to achieve. Nevertheless, there is value in attempting such an exercise and in promoting greater awareness of the policy and techniques adopted in the major financial centres of the world. The need to examine

the legal basis underpinning insolvency practice in a specific jurisdiction should not prevent serious analysis of the questions raised in this paper.

Cost Considerations

13. It should be recognised that costs incurred in providing greater protection for investors will often ultimately be borne by the investors themselves. While measures which enhance market integrity and heighten the security of client assets are advantageous and might very well more than compensate for the associated costs, it is important that national supervisors should take cost considerations into account in establishing a client asset protection regime.

Recommendation 2:

Regulatory authorities should choose within their jurisdictions those mechanisms which best achieve the overall objective of client asset protection, taking into account their national insolvency and investment services laws, regulations and practices; the needs of market efficiency and investor protection; and the costs of any such measures.

TRANSPARENCY

14. An important part of client asset protection is clients= awareness of what assets the firm is holding on their behalf, and of the arrangements which exist for their protection. Only if clients are aware of the level and type of risk to which their assets might be exposed can they make fully informed decisions about authorised firms and markets. Regular and timely reporting by firms to their customers about assets held on their behalf together with appropriate information about the arrangements for client asset protection, for example through the use of agreed standard forms of disclosure, will also assist investors to take action themselves to protect their assets. However, while reporting and disclosure about the way in which client assets are protected is a crucial part of effective client asset protection regimes, such disclosure alone should not be taken to be a substitute for other measures discussed in this paper.

15. Because of the way in which protections may be affected as a result of cross border dealings, especially where a number of firms are involved, disclosure of the risk of loss of protection of client assets should be a responsibility of the investment firm with whom the investor deals directly.

Recommendation 3:

Regulatory authorities should seek to ensure that investors are adequately informed about the arrangements for client asset protection within their jurisdictions. In particular, they should require that authorised firms report on a regular basis to their clients as to the assets which they hold on their behalf, and to make appropriate disclosure to clients about the way in which client assets which the firm holds are protected within their jurisdiction. Where client assets

are to be held in another jurisdiction, and different client protection arrangements apply to those assets, the firm should be required to inform the client of that fact.[2]

PREVENTATIVE MEASURES

16. In the day to day handling of client assets, the importance of preventative measures should be the first priority. Avoidance of the circumstances where client asset protection or compensation mechanisms must be relied upon in an insolvency affords the best protection for client assets.

Internal Controls

17. Firms should have robust systems of internal controls to ensure that the risk of loss of client assets through the firm=s insolvency is kept to a minimum. For this purpose, the most important controls are those that ensure that:

A proper books and records are kept at all times;

A assets held for clients, and dealings on their behalf, are clearly accounted for and safeguarded;

A internal and external audits are undertaken of key aspects of the firm=s business, including compliance with rules relating to client asset protection;

A accruals, rights and other entitlements are properly recorded; and

A there is regular reporting to external authorities on the operation of the internal controls dealing with the handling of client assets;

A there is appropriate segregation of duties between front office staff and staff responsible for administering client assets.

18. Many of these controls are also a prerequisite to effective protection or restitution of client assets in the event of insolvency. For example, the effective operation of trust arrangements, customer preference in insolvency or industry compensation schemes depends on the maintenance of records which correctly identify and account for client assets.

Recommendation 4:

Regulatory authorities and authorised firms should recognise that effective internal controls for identifying, accounting for and safeguarding client assets are essential prerequisites for effective client asset protection.

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2 Regulatory authorities may wish to consider approving standard forms of disclosure for use by authorized firms.

Regulatory Supervision

19. The importance of the effective protection of client assets held by authorised firms should also be recognised in the way that regulatory authorities plan and carry out their supervisory responsibilities. The question of whether an authorised firm holds or controls client assets should be an important factor in determining the intensity of regulatory supervision to which the firm is subjected. Inspection and reporting arrangements should give particular attention to the internal controls noted above. For example in those jurisdictions which rely on the work of external auditors, a review of the firm=s controls and procedures for handling client assets should be included in the scope of the auditors= work. In addition, regulatory authorities should ensure that capital adequacy requirements for investment firms which hold client assets are sufficiently prudent, reflect the risks to such assets and are effectively monitored.

20. Regulatory supervision of this kind may also assist in identifying firms which are at risk of becoming insolvent so that appropriate measures may be taken to avoid potential losses to client assets.

21. Action may be needed by regulatory or market authorities when they become aware that a firm's insolvency is likely or imminent. In some jurisdictions, authorities have power to take client assets out of the hands of a firm when they believe that the firm may fail or otherwise be unable to meet its obligations relating to client assets.

22. Many jurisdictions have insolvency regimes which require client assets, including positions, to be frozen upon the default of the investment firm. Not only can this adversely affect the clients involved, but can also affect overall market liquidity and the efficiency of settlement systems. It is important that any action taken in the course of the insolvency proceedings does not prejudice the ability of market authorities to deal quickly and effectively in unwinding or transferring client assets or positions to solvent market members or to the underlying clients.

Recommendation 5:

Regulatory authorities should:

i) recognise the need for appropriately intensive supervision of firms that hold or control client assets; and

ii) review the techniques and powers of intervention available to regulators or other relevant authorities both before and after the default of a firm which holds client assets.

SECTION 2 TECHNIQUES FOR PROTECTING CLIENTS OF INSOLVENT FIRMS

23. The basic types of protections available to clients whose assets are held by an insolvent investment firm are:

A legislative or other recognition that obligations to clients whose assets are held by the insolvent firm are to be treated differently from other obligations of the firm;

A provision for compensation to clients who sustain losses as a result of the holding of their assets by an insolvent firm; and

A measures taken by clients.

24. These mechanisms are not mutually exclusive and in many jurisdictions all play a part in minimising the risk of client losses.

25. The effectiveness of a particular technique may differ depending on the type of asset concerned (whether it is client money, securities or positions) and the insolvency legislation of the jurisdiction in which the assets are held.

PRESERVATION OF ASSETS IN INSOLVENCY

26. The method of meeting a defaulting firm=s obligations will normally be dictated by a jurisdiction=s insolvency legislation, or the interaction of its insolvency and financial services legislation.

27. In jurisdictions where client assets held by an insolvent investment firm are afforded differential treatment,[3] two main mechanisms may be used:

A mechanisms which provide that clients whose assets are held by the insolvent firm are to be given preferential status as creditors; and

A mechanisms which require client assets to be held in such a way that they do not become the property of the firm, and are therefore not assets of the firm that can be used to meet the firm=s obligations.

Preferential Creditor Status

28. Insolvency regimes often provide that some types of creditors rank ahead of others, so that some or all of the insolvent firm=s assets are to be used to meet the claims of these preferred creditors before they are available for settling the claims of other creditors. In some jurisdictions, a firm's ability to meet its obligations to clients whose assets it holds

3 In some jurisdictions different levels of protection in insolvency may also apply to different types of asset - for example differential treatment may apply to securities and positions but not to money.

or controls is secured by charges over general assets of the firm. Clients will thus receive preferential treatment by contrast with unsecured creditors of the firm. In certain jurisdictions, common law provides that assets which can be traced to a customer are held in trust by a firm. Although this does not generally apply to client money, it is possible that securities might be protected in this way.

Advantages and Disadvantages

29. The clear advantage of such an approach is that, subject to a possible change in statute, such a system can (but does not always) require little additional cost to firms (and therefore to investors), as it involves no operational changes while the firm is a going concern (with the possible exception of disclosure to creditors affected by such a policy) and is only effective upon the default of the firm.

30. A major disadvantage of systems relying solely on clients having preferential creditor status is that they can be ineffective where there is a shortfall in net assets of the insolvent firm. In that case, if this is the only method used to protect client assets, clients will be recompensed for the loss of their assets only to the extent that assets are available.

31. A second major disadvantage is that clients may in some jurisdictions be required to wait until the administration of the insolvency is advanced before it can be clear whether sufficient assets remain, which creditors have preference and in relation to what, and for other procedures prior to the distribution of assets to be completed.

32. This technique might also lead other creditors who would not be subject to preference to seek other means of safeguarding their assets, for example, liens and other charges or greater demands for collateral. An arrangement of this kind could reduce the pool of assets available for preferred creditors, including clients of the firm. Regulatory authorities can, however, make arrangements of this kind unattractive, for example by adjusting capital charges.

Continuing Client Ownership of Client Assets

33. Many regimes provide that, even though assets are held or controlled by an investment firm, they are not property of the firm available for distribution to the firm=s creditors in the event of its insolvency. Under regimes of this kind, the authorised firm may physically hold the assets (for example, securities) or deposit them with another person (for example, by depositing funds with a bank), but the client retains title to the assets and can assert title against the firm or the firm=s creditors. This separation of control of the assets from beneficial ownership of them can be achieved in a number of ways. In jurisdictions with a tradition of trust law, the regime often requires investment firms to hold client assets Ain trust≅ for clients. In other regimes, the same effect can be achieved by legislation which provides specifically that client assets held by an authorised firm are not available to meet the claims of the firm=s creditors.

34. These methods of protecting client assets are effective only if they are supported by measures that require client assets to be held so that they can readily be distinguished from proprietary assets of the firm. Measures of this kind include:

A the registration of securities in the name of the client or in a separate nominee company, for example with a regulated depository; or

A a requirement that client assets - or at least some types of asset, such as funds or securities - be held by a Acustodian≅, often with an additional requirement that the custodian be independent of the firm or be a third party nominated by the client.

35. These measures usually also involve an obligation to make clear to the custodian that assets held by it are not the property of the investment firm, but are held by the firm with the custodian on behalf of the firm=s clients.

Advantages and Disadvantages

36. Legislation that specifically provides that client assets held with or controlled by an authorised firm remain the property of the firm=s clients can provide a very effective means of protecting client assets. It may not, however, be without problems, which include:

A unless a jurisdiction=s insolvency legislation expressly deals with client assets, conflict between the jurisdiction=s insolvency regime and its securities or derivatives regime may undermine the protection of client assets;

A fraud by the firm, or by a custodian or trustee, can still take place;

A even where there are requirements for client assets and proprietary assets to be held separately from one another, assets may be commingled and it may be difficult to determine which are client assets and which are the firm=s proprietary assets;

A the costs of maintaining such a system, especially if it requires that assets be held by a third party such as a custodian, may be significant;

A in some jurisdictions, there may be indirect cost consequences for the firm, for example if the firm is required to pre-fund margin calls.

37. In the case of regimes which rely on the jurisdiction=s general trust law, the following drawbacks may also exist:

A a non-statutory trust is enforceable only in certain jurisdictions;

A for a trust to be fully effective in protecting client assets, it may be necessary for a third party receiving the assets (such as a custodian) to be aware that the firm is merely a trustee of those assets; and

A a trust can be ineffective, as a matter of law or in practice, if the firm=s money is inadvertently mixed with the client money in the trust account, although in some cases (for example the US and the UK) firms are permitted in certain clearly defined circumstances to add their own funds to the segregated pool.

38. The main advantage of using a custodian is the safeguard to investors of having their securities lodged there, which, in the event of the investment firm=s default, enables them to be readily identified and isolated from assets of the insolvent firm. It should be noted, however, that clients in these circumstances are exposed to the risk of insolvency of the custodian, so that these measures only add to the protection of clients if the custodian or other third party by whom client assets are held is at least of the same credit standing as the authorised firm.

39. The disadvantages of assets being held by a custodian include the additional time and cost involved in maintaining separate accounts in order to distinguish between the firm=s and its clients= assets and, most importantly, the risk that it might not be legally effective, especially in overseas jurisdictions. Effective separation of firm and client assets can in these circumstances depend critically on the quality of the records at both the firm and the custodian, as poor records can prejudice the ability to prevent a liquidator from claiming uncertainty over the ownership of the assets. Subject to the insolvency law in each jurisdiction, it may be that certain other measures might have to be taken to ensure that, in respect of their assets held by an investment firm with a custodian, clients have preference and do not merely rank equally with other creditors of the defaulting investment firm or custodian.

40. A requirement to hold assets with a third party subject to the control of the customer may also disadvantage the firm by reducing its operational liquidity, and may have a detrimental effect on the speed and efficiency of settlement processes.

41. The effectiveness of separate holding of assets may also vary according to the nature of the asset. Where an asset is separately identifiable as client property (for example a registered security), separation may be a far more effective technique for protection than in the case of cash, where the deposit will ordinarily lead to a debtor/creditor relationship with the custodian concerned.

Securitisation of Money

42. The established way of depositing client money is with banks. Various issues concerned with the relative risks of depositing money with banks as opposed to investment firms are discussed elsewhere in this paper. Additionally, banks are prohibited in certain jurisdictions from paying interest to non-residents. In some jurisdictions, an alternative to deposits with banks is to deposit funds with specialist money funds. Securitisation need not, of course, be restricted to the use of money funds, although such funds would normally have an enhanced credit rating attractive to investment firms wishing to deposit client money with them.

Advantages and Disadvantages

43. Authorised firms and investors should be aware that there might be an element of market risk inherent in the use of money funds. It is important to note the investment objectives of a specific fund in order to measure such risk. A further issue relating to securitisation is that it would normally involve the pooling of client money, rather than the maintenance of individually designated client money accounts, which some clients find more attractive. The risks inherent in pooling client money are discussed elsewhere in this paper.

COMPENSATION ARRANGEMENTS

44. The main methods used to ensure that clients are adequately compensated for losses include:

A establishment of schemes to compensate clients who lose assets as a result of the insolvency of an investment firm; and

A a mandatory requirement for securities firms to obtain private insurance against the risk of loss of, or a shortfall in, client assets.

Compensation Schemes

45. Compensation schemes are commonly used to compensate clients for losses arising from misappropriation of assets by a firm or its employees, as well as being available to meet shortfalls in client assets held by an insolvent firm. They normally involve arrangements established by legislation, or by regulatory or market rules, which provide for funds to be available to compensate investors who suffer losses of this kind. Schemes of this kind may be organised on a jurisdictional or industry basis and may depend on some other connection, such as membership of an exchange. Funds to meet investor claims are normally contributed by industry participants or classes of participants (such as members of securities or futures exchanges).

46. Compensation schemes are, therefore, a way in which market participants collectively contribute to a fund used to compensate clients of a failed firm. The scope of these compensation schemes can vary considerably. Some schemes provide compensation only in the case of fraud or theft of client assets, where the authorised firm concerned is unable to make good the losses, or quite simply a deficit of client assets upon the default of the firm. The timing involved in settling compensation claims varies from scheme to scheme and according to the complexity of both the insolvency and the claim.[4]

[4] Compensation schemes should be distinguished from clearing guarantee arrangements which are established by exchanges and clearing houses to guarantee to members of an exchange the performance of transactions in the event of the failure of another member of the exchange to settle a transaction. Nevertheless, such schemes can indirectly assist in the protection of client assets and play an important role in the overall assurance of market integrity and investor protection.

Advantages and Disadvantages

47. An important advantage of compensation schemes is that their operation is separate from the insolvent firm. Furthermore, their costs are spread across a wide range of market participants.

48. Disadvantages inherent in compensation schemes include the fact that usually only cover up to a specified amount and there may be different levels and types of cover across different jurisdictions, so that, for example, persons eligible for compensation as Aclients≅ in one jurisdiction may not qualify as clients in another. Moreover, such schemes are not ordinarily designed to prevent the resultant freezing of clients= assets and positions upon insolvency. Compensation schemes are simply designed to repair the damage at a later date. They impose a cost on firms which are not likely to fail, although proponents of compensation schemes contend that all firms benefit from the increased confidence which such schemes create in markets.

Insurance

49. While not directly protecting the assets of investors, various forms of private insurance can protect the interests of investors by providing indemnification against losses involving client assets. In some jurisdictions, regulatory authorities require authorised firms - whether individually or collectively - to take out insurance of this kind. One such form of insurance is a mutual insurance policy subscribed to by all users of a particular market. This would involve all market participants undertaking to stand behind the transactions or liabilities of the other participants. This is similar to a form of compensation fund. Another form of insurance is commercial insurance, whereby market participants obtain default cover either individually or collectively from the insurance market. This might cover fraud, faulty execution, loss of documents or unauthorised trading by a firm=s employees.

Advantages and Disadvantages

50. Insurance has the same advantages as preference in insolvency, namely those of simplicity and a lack of operational involvement of the firm. In addition, it can improve the standard of control within a firm, as insurers generally require a firm to perform a comprehensive review of its internal control structure before confirming cover. The disadvantages of insurance include those of cost, the fact that most insurance policies involve a maximum level of cover and, in practice, the various exclusions from any insurance policy. For example, in some jurisdictions and with certain products, it might not be possible to obtain cover for default losses. There is also the possibility that a firm which is approaching default might not comply with the strict conditions of an insurance policy designed to protect the firm=s investors. In many insurance markets there is also the problem of capacity, especially with a specialist risk such as investment firms.

MEASURES TAKEN BY CLIENTS

51. It should also be recognised that clients dealing with investment firms may themselves take measures for the protection of assets held by the firm on their behalf. Needless to say, the ability to negotiate such arrangements with a firm will vary from client to client. It may also be the case that such schemes will not work in jurisdictions where clients are required to be treated equivalently upon the default of the firm. Nevertheless, some examples of this type of arrangement are where:

A investment firms provide their own securitisation by the payment of client money into a money fund operated by the firm;

A the client enters into an arrangement with the investment firm to collateralise a cash balance;

A clients establish accounts in their own name at banks or custodians and permit an investment firm to exercise control over those accounts;

A clients protect their assets through the use of letters of credit or other arrangements with their bankers, so that money is only provided against proper documentation;

A clients require special arrangements to recognise or preserve their right to a particular asset; or

A the effective execution of transfer of positions by clients in certain jurisdictions upon the insolvency of the firm.

Advantages and Disadvantages

52. Private arrangements for client protection may be tailored to address specific risks identified by the parties to a transaction. For example, clients who are creditors without the benefit of preferential status may seek other means of safeguarding their assets, for example by liens and other charges or the greater use of collateral.

53. However, private arrangements of this kind have a number of limitations. Among the most important are:

A the time and cost of negotiating appropriate protections may be prohibitive;

A the cost of enforcing them may be substantial;

A the relative bargaining position of the parties may mean that clients are unable to negotiate effective protections; and

A unless expressly provided for in a jurisdiction=s insolvency regime, some of these arrangements may not be fully effective if the investment firm becomes insolvent.

54. In view of these limitations, private arrangements should not be regarded as a complete substitute for protections provided through the normal regulatory process, even in the case of Aprofessional≅ clients.

55. Nonetheless, securities and insolvency regimes should not impede clients of investment firms from taking prudent steps to protect their assets, unless it would be inconsistent with policy objectives related to protection of the markets or equivalent treatment of customers in default.. This is another reason why transparency of the various asset protection techniques is so important.

SECTION 3 ISSUES RELATING TO CLIENT ASSET PROTECTION GENERALLY

SELECTION OF CUSTODIANS

56. Given the volume of client assets held with unrelated custodians, it is of utmost importance that attention be paid to selecting appropriate custodians. Failure to do so may reduce the protection available to client assets where they are required to be held with third parties. For example, if an authorised firm has a high credit rating, holding its clients= assets with a poorly rated third party may effectively expose them to increased risk. In addition, the consequences of selecting particular types of third party should be made clear. For example, if the third party is a bank, it is important to note that different compensation arrangements might apply on its default and this could impact either the firm or the customer, depending on the jurisdiction, particularly as banking industry compensation schemes may cover just money, not securities.

Recommendation 6:

Regulatory authorities which require the use of third parties to hold client assets should, where appropriate to their client asset protection regimes, set criteria for the selection of such custodians with the objective that the level of protection enjoyed by clients should be maintained, if not enhanced, and the nature of any risks adequately disclosed.

THE USE OF RELATED FIRMS AS CUSTODIANS

57. While there is a widespread commercial practice by investment firms of using related parties for the safekeeping of client assets, the risk to the clients through intra-group contagion can be increased. The default of an investment firm is rendered much more likely, for example, by the default of a related custodian bank than by an independent third party. It is important for clear criteria to be set for permitting the practice of using related parties for the safekeeping of client assets. This is particularly relevant when the regulatory regime for client asset protection requires that assets be held with a separate custodian.

Recommendation 7:

Regulatory authorities should carefully consider the circumstances in which authorised firms may be permitted to meet the requirements of a client asset protection regime by holding client assets with a related custodian. Where they are, there should be clearly defined criteria for the practice of selecting those related third parties. These should include clear disclosure of any different risks to clients, particularly the implications, if any, for compensation schemes.

RESPONSIBILITY FOR THIRD PARTIES

58. Although it is increasingly the case that clients elect to use a specific third party for the deposit of funds or securities, it is still common for an investment firm to make that choice. Concern has recently been expressed about the lack of formal responsibility on the part of investment firms for the acts or omissions of their own nominee companies, and custodians and about the level of due diligence which should be exercised by investment firms in the choice and ongoing monitoring of such third parties. The issues here relate to the need for transparency of the risks associated with holding assets in different jurisdictions, the need to determine who carries those risks (the investors, the firm or the custodian) and the need to determine liability in the event of the default of the custodian.

Recommendation 8:

Regulatory authorities should as far as possible decide on and clarify the extent to which investment firms should accept responsibility for the choice and conduct of banks and custodians which hold client assets on their behalf and the extent to which the client will be liable on the default of that third party. If responsibility is not accepted by the investment firm, that fact should be made clear in client documentation.

DEALING THROUGH UNRELATED FIRMS

59. Much securities and derivatives business involves a number of parties to a chain of transactions in order for a client=s instructions to be fulfilled. For example, a client wishing to buy securities might need to use a broker through which to purchase or sell securities or to gain access to an exchange member for dealing in derivatives. In dealing with a chain of firms, clients run the risk that any assets passed to an investment firm might lose the character of client assets if passed to an investment firm which is not subject to the type of rules envisaged by this paper. The integrity of client assets is only preserved if they are passed to a firm which itself extends broadly similar protection for client assets. This can only be achieved if client assets are clearly identified as such when passed to another firm. In this context, particular attention should be paid to the regulatory arrangements which apply when a firm receives client assets from another market professional. If such market professionals are not afforded client asset protection in their own right, retail clients dealing through such professionals might not be protected.

Recommendation 9:

Regulatory authorities should ensure that, where a firm deals with an unrelated firm within their jurisdiction, client assets are identified as such to that third party and equivalent protection is afforded to any such assets.[5]

DEALING THROUGH RELATED FIRMS

60. The issues relating to dealing through a chain are exacerbated when parties in the chain are related firms. Client asset protection might be lost because a firm is not permitted to treat a related firm as a client for client asset protection purposes. For example, in some jurisdictions client assets received from related firms are treated as intra group balances and thus do not benefit from client asset protection arrangements. In addition, the risk to clients is different because of the likelihood of related parties becoming insolvent at the same time. Client assets may, therefore, be lost wherever they are held in the chain.

Recommendation 10:

Regulatory authorities should ensure as far as practicable that where an investment firm deals through a chain of related parties within its jurisdiction client assets are separately identified from the proprietary assets of the group, and client asset protection arrangements available at the initial point of dealing are preserved throughout the chain.

CROSS-BORDER DEALINGS

61. When dealings involve assets crossing into other jurisdictions, additional risks arise for clients. The most important of these is the risk that assets passing from one jurisdiction to another might not be classified as client assets in the jurisdiction in which they are received, and will therefore not receive protection as client assets. Confusion can arise as to where the account resides and therefore which client asset protection regime applies.

62. There are positive advantages in reducing these risks by ensuring that client assets, where passed to another investment firm, are clearly identified as such. This process of seeking protection along a chain of cross-border transactions would, of course, be further facilitated if receiving firms were also required by their regulators to apply protection to any assets received from another investment firm bearing the identification as client assets.

Recommendation 11:

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5 For example where Firm A deals with Firm B, it should separately identify any client assets it passes to Firm B from its own proprietary assets and require client asset protection for those client assets. However, if Firm B then deals with Firm C it is not necessary for the purposes of client asset protection for Firm B to separately identify to Firm C the client and proprietary assets of Firm A, provided Firm A and Firm B are unrelated.

Regulatory authorities should:

i) ***consider extending client asset protection within their own jurisdiction to assets received by investment firms which are classified as client assets in the jurisdiction of the firm from which the assets are received; and***

ii) ***should require that client assets are identified as such and appropriate protection is requested for them by firms in their jurisdiction when these assets are passed to firms in other jurisdictions.***[6]

OMNIBUS ACCOUNTS

63. For the purposes of this paper, an omnibus account is defined as an account held by an investment firm with a third party in which client assets are held in aggregate, rather than in individually designated accounts by client, but which nevertheless ensures that the assets are segregated from those of the firm.[7] Omnibus accounts may play an important part in ensuring the effectiveness of market settlement systems, for example by enabling clearing houses in futures markets to guarantee fully the settlement of all trades, whether or not all clients have met their margin obligations. While the operation of an omnibus client account is effective in many jurisdictions, that is not universally the case. In certain countries, the liquidator of an investment firm does not have any obligation to treat the assets held in an omnibus client account as distinct from the firm=s own assets if the client accounts remain designated in the name of the firm. In other words, an account entitled AXYZ and Co-Client Account≅ might be ineffective and only individually designated clients= accounts with the bank or custodian in question would be safeguarded in the event of the investment firm=s (but not necessarily the bank=s) default. Individually designated accounts offer the advantage of protecting clients not only from the default of the firm, but also from that of other clients. This distinction becomes particularly significant where a firm defaults because of losses arising on a particular client=s account. Nevertheless, a number of mechanisms, such as the requirement to balance the omnibus account with clients= positions on a daily basis, can be employed to minimise the risks associated with such accounts.

Recommendation 12:

Regulatory authorities should consider measures to ensure that the use of omnibus accounts does not unduly prejudice the overall objectives of client asset protection within their

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[6] See footnote to Recommendation 9.

[7] The term >Omnibus Account= is sometimes also used to refer to an account in which the client and proprietary assets of an investment firm are commingled. The lack of segregation within accounts of this type can place any client assets held in the account at significant risk in the event of the insolvency of the investment firm.

jurisdictions. Investors should be made aware of the risks inherent in the use by authorised firms of omnibus accounts.

OPTING OUT

64. The importance of public policy has been mentioned several times in this paper and it is especially relevant to the issue of opting out of client asset protection. The question has arisen in many jurisdictions as to whether the same degree of protection should be provided for all types of investor - or indeed whether certain investors should be given protection at all. In jurisdictions where client asset protection is seen only as customer and not market protection, it is often accepted that clients who are market professionals require no client asset protection and that private or Aretail≅ investors do. For other investors, perhaps more financially aware than many private investors, but without the detailed knowledge of the financial markets assumed on the part of market professionals, the question is less clear-cut. While the advantages of client asset protection are clear, it is worth outlining the advantages of permitting such investors to opt out. If an investment firm is not required to provide asset protection to professional clients, it can reduce its operational costs accordingly. As long as such cost reductions are reflected in reduced costs for investors, there can be a benefit as well as a cost attached to a lack of client asset protection. In order for investors to make such a cost / benefit decision, they must be adequately informed about the nature of the protections foregone, the nature and credit standing of the firm with which they are dealing and the bank with which their money will be deposited, the compensation arrangements applicable to their money and the relative cost considerations of opting out.

65. If client asset protection is deemed to be an important factor in overall market confidence and integrity and in facilitating the transition of funds from and the isolation of risk to a failing firm, some might argue that such protection should apply regardless of the status of the client. Others argue that it is important to analyse the different types of protection which are combined within an overall framework and to decide to apply such protections to different types of client as appropriate.

Recommendation 13:

Where regulatory authorities permit opting out of client asset protection, they should establish clear criteria under which particular classes of investors are able to do so and ensure that any material consequences of so doing are made clear to those investors.

SECTION 4 PROTECTION FOR PARTICULAR TYPES OF ASSETS

66. This section deals with issues relating to client asset protection as it applies to different types of asset.

CLIENT FUNDS

Banks Acting as Brokers

67. In most jurisdictions, the regulatory arrangements for the protection of client money are designed to apply to money placed with a broker rather than with a bank. Where a bank receives money from customers in the course of undertaking investment services business, it will usually hold these funds as deposits rather than as client money, and banking protections will apply to these funds. This paper does not set out to compare the protections available to money held by banks and investment firms, merely to state the importance of recognising and disclosing where necessary that there are differences in this respect.

68. Nevertheless, an important issue which arises from this difference between banks and investment firms is the question of whether, where there is a bank involved as broker in a chain of dealing, the bank concerned should require segregation of any client money which it passes to intermediate brokers, exchanges or clearing houses. There are clear advantages in requiring banks, where they act as brokers, to be subject to the same client asset protection regime where client assets are passed by them to another authorised firm. The protection would not fail part of the way along a chain merely because an investment firm chooses to deal with a bank as intermediary rather than another investment firm.

Recommendation 14:

Regulatory authorities should ensure that when a bank passes clients' money to a third party in the course of undertaking investment business on behalf of clients,

i) it separately identifies the funds as relating to dealings on behalf of clients; and

ii) to the extent possible it seeks client asset protection from the third party to whom such monies are sent.

CLIENT SECURITIES

ussing issues relating specifically to client securities, it is important to recognise that investment firms either hold or control client securities of increasingly significant value, far greater than in the case of client money. As settlement periods become shorter and book-entry systems become even more widely used, the value will continue to grow. This fact makes the issues relating specifically to securities that much more significant.

Regulated Activity

Jurisdictions vary as to whether the safe custody of securities is subject to overview by the regulatory authorities, whether in the context of investment services or of banking business.

71. There has been significant debate among regulators and major custodians on this issue. In favour of the regulation of custody is the argument that huge amounts of securities are entrusted by customers to custodians, who represent that they will handle those securities and account for them in accordance with the legitimate instructions of the owners of the securities. The purpose of regulation in this situation is to help minimise the risk that those expectations will be disappointed. This is, of course, a very persuasive objective. Against that lies the argument as stated above that much of the international custody activity is already regulated. Indeed, in addition to supervision by the regulatory bodies, it has been argued that many of the customers, especially large institutions such as pension funds and major corporations, insist on high levels of internal control being demonstrated to themselves or their auditors.

72. A major aspect of the discussion on the regulation of custody activities has to be that of cost and the need for careful definition as to what constitutes custody, and the use of appropriate supervisory techniques to oversee firms which undertake this activity.

Recommendation 15:

Regulatory authorities should review the regulatory and supervisory arrangements for custody in their jurisdictions.

Stock Lending

73. As a result of shorter settlement periods, the risks inherent in physically holding securities and the prevalence of dematerialised or immobilised securities, a large proportion of customers= securities are held or controlled by investment firms or banks. In addition, many investors seek to maximise the return on their holdings and the firms wish to provide additional services, such as stock lending. There are a number of additional risks arising out of the lending by firms of customers= securities. The main one to be emphasised in this paper is the need for legal certainty as to the owner of the securities and who takes the responsibility for completing stock lending transactions and for the default of counterparties to such transactions. It is essential that securities lending transactions should be subject to clear, preferably industry-standard, legal documentation.

Recommendation 16:

Regulatory authorities should ensure that regulations provide for:

i) the prior authorisation by customers of securities lending activity;
ii) clarity as to who is assuming the risks in securities lending transactions;

iii) the need for clear, industry standard documentation; and

iv) adequate regulation and appropriate supervision of securities lending activity.

Settlement Accounts

74. Much of the securities business conducted worldwide is settled on a delivery-versus-payment basis. Although the vast majority of DVP transactions settle without any difficulty, it can happen that there are timing differences between receipt of securities and passing of cash. Clearly if both do not occur simultaneously, one party to the transaction will be at significant, albeit usually short-term, risk. The risk to clients would be the default of an investment firm at a time when client assets are in the course of settlement. In such a scenario, clients= securities may have been delivered to a clearing house or the investment firm=s custodian. In either case, if the client has not been paid for the securities, the client is at risk unless there is specific treatment of client assets in the course of settlement, such as the maintenance of separate settlement accounts at custodians and clearing houses which ensure that clients= securities are not mixed with those of the firm.

Recommendation 17:

Regulatory authorities should review the adequacy of arrangements within their jurisdiction for ensuring that client securities in the course of settlement are not unnecessarily mixed with those belonging to the investment firm.

CLIENT POSITIONS

Agency / Security Interests

75. Most of the world=s derivatives markets operate on a principal-to-principal basis. In certain cases, however, most notably where an investment firm is dealing on behalf of a client, the substance of the transaction is more of an agency transaction. In order to protect client positions arising from such transactions, there needs to be the ability (in law and in practice) to recognise the interest of the client in the transaction and, more importantly, to remove a defaulting investment firm from the chain where it is effectively dealing as agent.

76. The disadvantages of an arrangement which allows the removal of the firm are, however, twofold:

   a) As most of the world=s derivatives markets are principal-to-principal, it may not be possible to change the legal structure of a transaction without legal or regulatory support;

   b) It is not possible simply to remove an agent from a transaction if any of the assets (e.g. margin) belonging to any party to the transaction have been lodged with the defaulting firm and are no longer available.

Recommendation 18:

Regulatory authorities should ensure that there is clarity as to the arrangements for protecting client positions held as a result of transactions entered into in their jurisdictions.

Consistency of Provisions Applying to Firms and Clearing Houses

77. In the event of an investment firm=s default, it is common for the liquidators to freeze not only the assets of the firm, but also any outstanding positions. In the absence of any separate identification of clients= positions, it is likely that those will also be frozen, not only by liquidators but also by exchanges. Segregation (i.e. separate identification) of positions is designed to ensure that transactions can be transferred or closed out speedily by the exchange or clearing house (unless the default is due to severe market action) without the need for the delay of remitting further funds.

78. In the event of an insolvency, the priority for many clients is either to transfer or liquidate their positions as quickly as possible. Any transfer of client positions will be frustrated if the firm holding the position cannot be compelled to transfer them to a solvent firm. Furthermore, clearing house rules will not bind a firm which is not a member. This is a particular problem in the case of related party transactions, as both the exchange member and non-member are likely to be in default.[8]

Recommendation 19:

Within each jurisdiction, to the extent possible, the regulatory regime should facilitate the transfer of positions from firms including related party firms which have become insolvent. Arrangements at clearing houses should be consistent with the objective of client asset protection at authorised firms and in particular have arrangements which permit the separate identification of client and proprietary positions.

Margin Segregation

79. A very effective way of protecting clients= positions is to ensure that all positions are effectively margined and that client positions are margined separately from those of the firm and non-segregated clients. Although this does not necessarily prevent positions from being frozen upon the default of the firm, it is designed to ensure that customer transactions do not offset firms= liabilities and thus their transactions can be transferred or closed out speedily by the exchange or clearing house (unless the default is due to severe market action) without the need for the delay of remitting further funds.

Recommendation 20:

Regulatory authorities should ensure that the provision of margin is the subject of clear, written agreements between the firm and its clients and that the firm should operate

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[8] See also the Technical Committee's report entitled Default Procedures published in March 1996.

appropriate internal controls to ensure that margin posted for client positions is properly accounted for and segregated on behalf of such clients.