EU legal and regulatory developments

Safeguarding of client assets: CESR's technical advice in relation to Directive 2004/39/EC on Markets in Financial Instruments (MIFID)

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In June 2004, the Committee of European Securities Regulators (CESR) published a Consultation Paper containing its suggested draft technical advice to the European Commission on implementing measures for MIFID (CESR's Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments, CESR/04-261b). This was the subject of extensive feedback. CESR has now published its final advice to the European Commission on certain Articles of MIFID (CESR's Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments: 1st Set of Mandates (January 2005), CESR/05-024c).

The January 2005 Level 2 Advice in relation to the safeguarding of assets has been reviewed and compared with the draft Level 2 Advice set out in the June 2004 Consultation Paper. The results of such review are set out in Table 1.

Broadly, the requirements proposed for application to persons safeguarding client assets are not as onerous as the proposals in the June 2004 publication, but areas of concern still remain, for example the level

of risk warnings required to be given to not only retail clients but also professional clients.

There are certain other points to bear in mind when considering the January 2005 publication.

- In the June 2004 publication, CESR invited comments on whether it should advise the Commission to include grandfathering and transitional provisions in the Level 2 measures. In the January 2005 Feedback Statement (CESR/05-025), CESR simply notes that respondents to the June 2004 Consultation Paper were concerned that there should be appropriate transitional provisions, but states this 'is a matter for the EU Institutions to cater for additional transitional measures'.
- There is no indication that the safeguarding requirements should apply any differently to the possible different contexts for holding assets. For example, while it seems clear that global custody services should be subject to such requirements, the argument is less clear for pure trustee services (including acting

as trustee for unit trusts, a bond trustee or trustee in a securitisation) or services as nominee, escrow agent, issuer of depositary receipts or holder of safe deposits, where a high level of regulation may conflict with market practice in these areas.

- In Annex 1, MIFID refers to the ancillary service of ‘safekeeping and administration’, but Articles 13(7) and (8) refer to adequate arrangements to ‘safeguard’ clients’ ownership rights and clients’ rights in relation to funds without referring to administration. The explanatory text is entitled ‘Safeguarding of client assets’, and the Level 2 Advice refers throughout to an investment firm ‘holding’ client assets. The explanatory text in the Technical Advice in the Definitions section states that ‘The application of the relevant provisions should be left to Member States to determine at national level’ (although this is in the context of references to ‘relevant persons’), and the explanatory text relating to the safeguarding wording states: ‘The provisions contained in this advice are without prejudice to the ability of the competent authority to determine whether an investment firm is permitted to receive, handle or to provide safekeeping and administration

services in relation to client assets.’ It remains to be seen how CESR’s advice will be accepted by the Commission, and whether it will result in a further Directive or Regulations. Nevertheless, it should be remembered that, under the current regulatory regime in the UK, the regulations made under the Financial Services and Markets Act 2000 require an entity providing both ‘safeguarding and administering’ services to be within the scope of the regulations. If the result of a new Directive or Regulations was that the UK regulatory system was required to regulate all safeguarding (of financial instruments) whether or not administration services were also provided in relation to the same assets, this would be a considerable change from the current regime, and would cover various activities which are not currently regulated.

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Table 1: Specific comments (numbering from January 2005 Level 2 wording unless otherwise stated) on Box 1, Definitions, and Box 6, Safeguarding of client assets^a

<i>Change to Level 2 advice</i>	<i>Comment</i>
1 Definitions:	
1.1 ‘client financial instruments held on an omnibus basis’: this is a new definition but broadly tracks the wording appearing in parenthesis in 12(b) in the June 2004 safeguarding wording.	Note that this is narrower than the wording in the old 12(b), since it refers to ‘financial instruments of more than one client that are included in the same account on the books of the depository or financial instruments that are registered under the same designation on behalf of more than one client in the issuer’s register’ but does not say ‘or otherwise’. This does not therefore cover the situation where, for example, a custodian holds bearer instruments in its own vaults but does not record the specific instruments held for each client, simply stating that it holds a proportion of the instruments held for each of the relevant clients.
1.2 ‘depository’: this definition now specifically includes ‘clearing or settlement systems and central securities depositories’.	It should be noted that, as before, this term also includes banks with whom client funds are held. This is significant, because investment firms will have obligations regarding selection of settlement systems, etc. in addition to other sub-custodians, although is perhaps of less concern now that the obligation to accept liability for depositories of a specified level has been omitted.
2 Safeguarding of client assets	
2.1 The following issues have been dropped:	These changes are helpful.
2.1.1 Suggestion of specification of required ‘systems and controls’ to be put in place by investment firms to ensure only assets belonging to clients who have given consent are used for securities lending, where client assets are held on a pooled basis.	
2.1.2 Requirement for periodic AND annual review of depositories (now only require periodic review)	

2.1.3 Suggestion of identification of each depository used for a specific client	
2.1.4 Requirement of specific level of liability for depositories	
2.1.5 Requirement that records must be backed up regularly.	
2.2 Section 3. New wording clarifies that these requirements will apply in addition to any conduct of business requirements formulated pursuant to Article 19.	This is useful clarification.
2.3 Section 4. This wording still refers to the exercise of ‘due skill, care and diligence’ when making arrangements for the protection of the assets held in each jurisdiction in which the assets are held.	It is still unclear whether the level of ‘due skill, care and diligence’ is to be decided under the law of the jurisdiction from which the investment firm provides its services, or under the law of the jurisdiction where the relevant assets are held.
2.4 Section 5(a), (b). The reference to a ‘guarantee’ of safety of assets has been changed to ‘ensure’, but an investment firm must ‘ensure’ the relevant protection ‘to the fullest extent practicable’.	This is still an onerous obligation, since it may in practice be difficult to know what ‘to the fullest extent’ means, and is unclear whether it would ever be possible to state that no further action was required. The obligation is, as before, modified by reference to what is practicable, but note that this is a higher level than reference to what is ‘reasonably’ practicable.
2.5 Section 5, final paragraph. This now includes clarification that the Section 5 requirements do not prevent the exercise of rights granted to third parties by the client over its assets, in addition to, as previously, investment firms and depositories having lien, set-off or security rights.	This is useful clarification.
2.6 Section 6. This section contains restrictions on the use of one client’s assets for another client, as before.	Note that in the explanatory text CESR does not regard holding assets for different clients on a pooled/omnibus basis as using the assets of one client for another.
2.7 Section 6(a). A client formerly was required to give express consent in writing, but the requirement is now to	The form of evidence of consent has been relaxed slightly, although the new requirement of ‘prior’ consent will mean that an investment

Change to Level 2 advice

Comment

- give ‘prior’ consent, and such consent must be evidenced by signature ‘or an equivalent alternative mechanism’ (presumably some form of electronic signature).
- 2.8 Section 6(c). There is a new requirement that the documentation requesting consent (or document cross-referred to in the document requesting consent) should be provided ‘in a durable medium’ (broadly a medium where information is stored and accessible for future reference).
- 2.9 Section 6(c)(ii). In a new limitation, a risk warning of the use of client assets for another need only be given to retail clients.
- 2.10 Section 7(a). The requirement for consent to lending has been made more restrictive, because not only is client consent required, but such consent must be ‘evidenced by signature or an equivalent alternative mechanism’.
- 2.11 Section 7(b). In the context of systems and controls to restrict availability of securities for lending, the same change has been made as in 7(a) and the wording now specifically requires ‘prior’ consent.
- 2.12 Section 9, final paragraph. The wording in parenthesis has been extended by the insertion of ‘and (iii) when the credit institution or the bank holds such funds as deposits on its books’.
- firm must not rely on a client agreeing to procedures after the event.
- Arguably notification to a professional client is sufficient, rather than requiring consent.
- This gives more flexibility regarding the manner of provision of the relevant information.
- This is helpful.
- Oral consent will therefore not be acceptable without appropriate evidence.
- As above, and consent after the event is not permitted.
- Presumably this is intended to mean that the requirements which apply to selection of a depository (which includes banks) only disapply Section 10(a)(i) and (iii) when the relevant bank owes the cash held, but not if it holds the cash in an account with a third party bank and holds the benefit of such account for the investment firm.
- Note that the matters to be taken into account, and the obligation to use a regulated entity, in Section 10 apply to the selection of banks in addition to Section 9.

- 2.13 Section 10(a). As before, this refers to the exercise of ‘all due skill, care and diligence’ in the selection, etc. of depositories. Same issues as re Section 4 (4.3 above).
- 2.14 Section 10(a)(i). The approach taken in relation to use of depositories which are regulated institutions is that if ‘holding and safekeeping’ of client assets is subject to ‘specific regulation and supervision’ in a jurisdiction, then the investment firm must use a depository in the relevant jurisdiction which is subject to regulation and supervision. The possibility of ‘overriding considerations’ has not been incorporated, nor has CESR accepted the suggestion that regulation should just be another factor to consider. This requirement sits somewhat oddly in 10(a), since the other points are simply matters to be taken into account. Note that the depository to be used is not required to be subject to the specific regulation of ‘holding and safekeeping’, just to ‘specific regulation and supervision’. This may be a drafting error. Query how this applies if, as in the UK, ‘safekeeping and administration’ are regulated, but not ‘holding and safekeeping’. Also, query what happens if ‘holding and safekeeping’ are regulated if carried out by certain entities, say banks, but not if carried out by other entities. This wording does not take account of the fact that levels of regulation and supervision may vary in different jurisdictions, therefore a regulated depository may not always be the appropriate choice.
- 2.15 Section 10(b). As before, requires client assets to be separately identifiable from assets of investment firm or depository ‘to the fullest extent practicable’. Same issues as for Sections 5(a) and (b) (see 3.3 above).
- 2.16 Section 10, final paragraph. In addition to the points in 10(a), new factors may also be taken into account when selecting a depository, namely the client’s instructions and legal or market conditions. It is unclear what happens if such factors conflict with the specific requirement in 10(a)(i).
- 2.17 Section 12(a). The wording ‘held by the investment firm’ has been deleted. This may be an oversight, but without it, the wording could be construed as requiring an investment firm to maintain records enabling the

- client's assets to be promptly identified at the level of the sub-custodian, which is not possible where assets are held in omnibus accounts with the sub-custodian.
- 2.18 Section 13, first paragraph. Previously an investment firm was required to enter into an agreement in writing with the client. The new requirement is to provide terms 'in a durable medium' and to obtain the client's consent 'as evidenced by signature or an equivalent alternative mechanism'. In addition, the terms must set out the investment firm's 'responsibilities' as well as its rights and obligations.
- 2.19 Section 13(a). Although an investment firm must state that assets may be held by a depository if this is the case, there is no required level of liability for depositories, just a requirement to state what level of liability is accepted for the acts, omissions or insolvency of the depository.
- 2.20 Section 13(b). As before, if holding assets on an omnibus basis, the terms must describe 'the risks arising as a result of that fact'.
- 2.21 Section 13(c). As before, if not legally possible or practicable because of local market practices for client assets held with a depository to be separately identifiable from the assets of the depository or the investment firm, investment firm must say so and give 'appropriate, prominent warning of the risks arising as a result of that fact'.
- This gives more flexibility for the form of terms, but applies to all clients, therefore an investment firm could not just provide terms to a professional client and not obtain signature.
- It is not clear what the inclusion of 'responsibilities' adds.
- This is helpful.
- This applies to all clients, whether retail or professional. This is arguably not necessary for professional clients. The argument that such risk description is not necessary in order to make 'adequate' arrangements as required by MIFID still applies.
- Arguably additional risk warning not necessary for professional clients.

2.22	Section 13(d). This is now revised so that only a 'general' description of the way in which client assets are protected in the relevant Member State is required, and for assets held in another jurisdiction, only 'statement of' the fact that different protections may apply.	This is worrying because:
(a) It applies to all clients, not just retail clients.
(b) It apparently contemplates something more than the relevant investor compensation scheme and deposit guarantee scheme, although such schemes must be included in the description. If this is interpreted as a requirement for a description of the basis on which the investment firm holds the assets, for example a description of trust law, this is a concern, because an investment firm may not be able to give legal advice, and may be liable for any errors in such a summary (the inclusion of the word 'general' does not really assist). There is also a risk that this could be construed as giving investment advice.
(c) Will an investment firm be able to provide an accurate (and up to date) description of client protection arrangements in all the jurisdictions in which it holds assets for the client? The issues mentioned in (b) apply equally.
2.23	Section 13(e). This requires a statement of 'the terms' of any security interest, lien or right of set-off taken by the investment firm, rather than a 'description'.	This could be interpreted to mean rights implied by general law (banker's lien or set-off, trustee's right of indemnity) must be specified?
2.24	Section 14(b). The obligation to check now only applies to 'record' not 'procedures'.	This is helpful.
2.25	Section 14(c). This now refers to 'periodic' independent review.	This seems sensible.
2.26	Section 15. This now also applies to 'records provided for in paragraph 6'.	It is unclear what records are referred to.
2.27	Section 16. This extends the obligation of external auditors, to report on 'the adequacy of the investment firm's arrangements'. The requirement to report on 'actual compliance' has been deleted.	It is unclear what arrangements are meant, and why reference to 'actual compliance' is omitted.

^aMinor changes are not discussed.