TRAVERS SMITH

Financial Services and Markets

CASS recast in time for Christmas

In just over five weeks' time, on 1 December 2014, the second phase of changes under the FCA's three-stage overhaul of the client assets regime will come into force. Compared with the largely low key clarifications introduced on 1 July 2014, the December changes will be more far reaching and substantive and will require practical changes to the way that firms which hold client assets do business with their clients.

The amendments to the FCA Handbook are being effected through revisions to the Client Assets Sourcebook ("**CASS**") and are the result of a consultation process which culminated in the FCA's policy statement and final rules in June 2014 (PS14/9) (http://www.fca.org.uk/your-fca/documents/policy-statements/ps14-09)

In Part 1 of this note, we outline the main amendments to CASS that will take effect from 1 December 2014. In Part 2 we set out in more detail what those changes will entail and suggest certain action points that firms should be considering. We also provide a brief reminder of the changes which are already in force. In due course, a third set of substantive changes will come into effect on 1 June 2015.

The rule references we have set out in this note are to the newly-introduced rules as they will appear on 1 December 2014. To see these on the online Handbook, use the "time travel" facility at the top of the screen and set the date at 1 December. Some of these rule references will change as of 1 June 2015 due to a restructuring at that time.

Part 1: changes to CASS on 1 December 2014 – an outline

The following changes may require re-papering of, or amendments to, a firm's existing agreements or terms of business:

- acknowledgement letters for client money accounts will need to be in a new standard format and must be countersigned by an authorised signatory from the relevant institution before client money can be deposited in the account;
- custody agreements must be documented in a legally binding written form and must cover certain minimum requirements;
- title transfer collateral arrangements must be documented in written form and must cover a minimum range of specified issues;
- where the banking exemption applies so that deposits are not treated as client money, the client must be notified prior to the provision of services that this is the case;
- disclosure requirements in relation to how a firm safeguards client money or assets that previously applied mainly to retail clients are being expanded to apply to all clients;
- firms relying on the delivery-versus-payment exemption for transactions effected through commercial settlement systems will need the client's prior written consent. Such firms should also note that since the scope of the exemption is being narrowed, the exemption may no longer be available in respect of some client arrangements;
- new rules permitting the transfer of client money in the context of the transfer of part or all of a firm's business will apply, but certain transfer methods will require prior client agreement; and

- new rules relating to unclaimed client money balances and client assets will apply, but only where these are consistent with the firm's agreements with its clients.

The following changes may require firms to review and amend their existing internal systems and controls:

- money must not be deposited in a client account until the firm has received an acknowledgement letter signed by a duly authorised person on behalf of the relevant institution with whom the account is held – the current "grace period" is being removed;
- new rules and guidance will apply to firms operating the "alternative approach" to client money segregation;
- the rules relating to the "non-standard" method of client money reconciliation are being amended;
- the FCA will need to be provided with assurances from an independent auditor before firms adopt either the "alternative approach" to client money segregation or the "non-standard" method of client money reconciliation; and
- the scope of the delivery-versus-payment exemption for transactions effected through commercial settlement systems is being amended and may be narrower than some firms previously understood.

Part 2: changes to CASS on 1 December 2014 – the details

Changes to CASS that will take effect on 1 December 2014 – no transitional relief

The changes in this section will come into force on 1 December 2014 without any transitional provisions.

Unclaimed client money balances (CASS 7.2.18G to CASS 7.2.26G) and allocated but unclaimed safe custody assets (CASS 6.2.8G to CASS 6.2.16G):

From 1 December 2014, a firm will be allowed to pay unclaimed client money balances to a registered charity of its choice (and in so doing, the money will cease to be client money), provided that certain conditions are met.

Broadly, these conditions are that:

- the payment of the money to a registered charity is permitted by law and is consistent with the arrangements under which the client money is held;
- the firm has held the client balance for at least six years following the last movement on the client's account (which excludes any payment or receipt or interest, charges or other similar items which do not require client involvement);
- the firm is able to demonstrate that it has taken reasonable steps to trace the client concerned and to return the outstanding balance; and
- the firm either gives a legally enforceable unconditional undertaking to pay to the client a sum equal to the amount of the balance paid to charity if the client were to seek to claim the balance in the future, or such an undertaking is made by another member of the firm's group and there is suitable information for clients to permit that member of the group to be identified.

The firm must make and retain records of all balances paid away to a charity in this way, including details of the client and amounts paid out, all relevant documentation in relation to the payment (including charity receipts) and details of the communications that the firm had or attempted to make with the client. These records must be retained indefinitely.

The evidential provisions as to what taking "reasonable steps" means include a somewhat protracted process of requiring the firm:

- to write to the client at his or her last known address;
- if there is no reply from the client within 28 days, to write again using some other means of communication;
- if there is no reply within 28 days to the second communication, to write again explaining that the firm intends to pay the unclaimed balance to a registered charity and that the firm, or another member of its group, will give an undertaking to pay the client an equal amount if the client seeks to claim that balance in the future; and
- to wait a further 28 days after that second communication before paying the amount to charity.

There is a *de minimis* alternative in the case of unclaimed balances of £25 or less for a retail client or £100 or less for a professional client. Here, the conditions are less stringent: while the balance must have been held for at least six years following the last movement on the client's account (as above) and the record-keeping requirements are broadly the same, the firm must

make at least one attempt to contact the client in order to return the balance using the most up-to-date contact details and may proceed to pay the money away if the client has not responded within 28 days of that communication (i.e. the "reasonable steps" process outlined above is not applicable). So, for *de minimis* amounts, there is no requirement to write to the client more than once or to give an undertaking to reimburse the client at a future date.

Similar rules will be introduced in respect of unclaimed custody assets held on behalf of clients, although in this case the firm will need to have held such assets for at least 12 years without receiving any client instructions before the unclaimed assets process can be initiated and there is no *de minimis* alternative.

While the changes in relation to *de minimis* client money balances are welcome, it is questionable as to whether the new rules as regards all other unclaimed assets represent a significant improvement to the existing position: the reasonable steps procedure is protracted and even where the client money or liquidated safe custody asset is paid away to a charity and ceases to be client money, an unconditional undertaking to reimburse the client must be given. It remains to be seen whether in practice there will be much appetite among firms for taking on the potentially large contingent liabilities that could arise from providing unconditional undertakings.

ACTION POINT:

- Consideration should be given to amending the terms of client agreements so that they expressly contemplate the payment of unclaimed client money and safe custody asset balances to a registered charity after the relevant periods of inactivity (6 years in respect of client money, 12 years in respect of safe custody assets) – i.e. so that the eventual payment away to a registered charity is consistent with the arrangements under which the assets are held.

Transfers of business involving client money (CASS 7.2.17AG to CASS 7.2.17GR):

Another context in which it has been difficult for firms to release themselves from their client money obligations is that of business transfers. The new rules will allow client money to be transferred to a third party as part of the transfer of all or part of a firm's business, and for the transferring firm's fiduciary duty to be discharged, in one of three ways:

- by obtaining the consent or instruction of the client at the time that the transfer takes place – i.e. the current position; or
- by transferring the client money to the third party on terms that require that party to return the money to the client as soon as practicable if the client so requests and provided that there is a written agreement between the firm and the client which provides that:
  - the firm is permitted to transfer the client's money to another party; and
  - either that third party will hold the money in accordance with the client money rules or, if not, the firm will exercise all due skill, care and diligence to assess whether the third party will nonetheless apply adequate measures to protect those sums; or
- where the amount of money held for the relevant client by the transferring firm is below the *de minimis* threshold (£25 for retail clients or £100 for any other client) and provided that under the terms of the transfer the third party is required to return the money to the client as soon as practicable at the client's request.

Where the firm transfers client money without obtaining the specific consent or instruction of the client to the transfer (i.e. in reliance on either the second or third conditions above), it must notify the clients that the transfer has occurred no later than seven days after the transfer takes place, providing the following information:

- whether the sums transferred will be held by the transferee in accordance with the client money rules and, if not, how such sums will be held;
- the extent to which the sums transferred are protected under an applicable compensation scheme; and
- that the client has the right to request that any sums transferred be returned to the client as soon as practicable.

The firm is also required to notify the FCA of its intention to rely on transfer terms contained in a written agreement or to rely on the *de minimis* threshold at least seven days prior to the relevant transfer.

ACTION POINT:

- Firms may wish to amend their terms of business for both new and existing clients in order to permit the transfer of client money to another party in connection with a business transfer.

Changes to CASS that will take effect on 1 December 2014 – with transitional provisions

The changes in this section will come into force on 1 December 2014, subject to certain transitional provisions in relation to pre-existing arrangements.

Acknowledgement letters (CASS 7.8 together with relevant Annexes):*

New requirements for acknowledgement letters are being introduced in order to standardise the approach in this area and as part of the FCA's efforts to minimise errors that it considered were frequently being made by firms. Acknowledgement letters are letters by which an institution (such as a bank) acknowledges that the legal owner of an account holds monies in that account on trust for others and that the institution is not entitled to exercise any rights of set-off or counterclaim which might otherwise be available against the account owner in connection with any balance held in that account. A new standard template acknowledgement letter must be sent by the firm to the entity with whom the client account is, or will be, opened and must be countersigned and returned by that entity. There are three templates: a client bank account acknowledgement letter (CASS 7 Annex 2), a client transaction account acknowledgement letter (CASS 7 Annex 3) and an authorised central counterparty acknowledgement letter (CASS 7 Annex 4).

The relevant template acknowledgement letter must not be amended, except in limited respects in order to provide the necessary information identifying the relevant entities and accounts, and must be printed on the firm's letterhead. If the counterparty amends the acknowledgement letter in a non-permissible manner, the firm must not place client money into the relevant account until a new, compliant acknowledgement letter has been obtained.

The current "grace period" of 20 business days (after which a firm has to withdraw all money standing to the credit of a client account if no acknowledgement letter is received) will be abolished. This means that from 1 December 2014 (subject to the transitional arrangements outlined below), a firm must have received a compliant acknowledgement letter in the correct form *before* it will be permitted to place any client money into the relevant client account.

The new rules will also require the firm to use reasonable endeavours to ensure that any individual that has countersigned the acknowledgement letter was authorised to sign on behalf of the relevant institution. New guidance is also being introduced by the FCA which suggests that reasonable evidence of a signatory's authority to countersign an acknowledgement letter may include an authorised signatories list, a valid power of attorney, use of a company seal and/or other materials which verify the status of the signatory. It is not clear that it will always be possible to obtain some (or indeed any) of this evidence, depending upon the particular counterparty. A firm will need to assess what evidence can be considered reasonable in the circumstances, but the FCA guidance emphasises that a firm is expected to seek the same level of assurance from the counterparty that it would seek if it were managing its own commercial arrangements. The countersigned acknowledgement letter and any other relevant documentation or evidence (such as evidence that the signatory was duly authorised) must be retained for at least five years from the date that the relevant account is closed.

Transitional provisions: The new requirements for acknowledgement letters apply to all new accounts opened on or after 1 December 2014. However, until 1 June 2015, the above requirements will not apply to client accounts that were opened before 1 December 2014, provided that the firm complied with the CASS rules that were in force prior to that date and the account is not transferred to another entity before 1 June 2015.

ACTION POINTS:

- Firms must use the new standard template acknowledgement letters for all new client accounts and must ensure that no prohibited amendments are made to the wording. This will require revision to existing policies and procedures.
- As regards pre-existing client accounts subject to the transitional provision, firms must ensure that their plans to repaper their existing acknowledgement letters with the new template letters are sufficiently advanced to meet the 1 June 2015 deadline.
- In respect of all new client accounts opened on or after 1 December 2014, firms must ensure that no money is deposited with the relevant bank or institution with whom the account is being opened until a valid counter-signed acknowledgement letter has been received. This is a significant change from previous practice, where a grace period was available.
- Firms need to seek evidence that the signatory representing the bank or institution with whom the account is opened is validly authorised to sign the acknowledgement letter. The nature of the evidence that can be obtained may depend upon the circumstances and is likely to be a matter of negotiation (at least until market practice becomes more settled), but firms will need to press banks to provide suitable comfort on this issue.

* On 1 June 2015, the section on acknowledgement letters will move to CASS 7.18.

Alternative approach to client money segregation (CASS 7.4.17AG to CASS 7.4.19CR):*

There are currently two different permissible approaches to client money segregation: the "normal" approach and the "alternative approach". The normal approach requires a firm that receives client money to either pay it promptly (and in any event, no later than

the next business day after receipt of that money) into a client bank account or otherwise pay it out in a manner which discharges the firm's fiduciary duty so that the money ceases to be client money (e.g. by paying it back to the client or to the client's authorised representative). Under the alternative approach, a firm may receive all client money into its own bank account, but is required to carry out reconciliations on each business day to determine whether there is an excess or shortfall of funds after the client money requirement is taken into account. The alternative approach is relevant for a firm that "operates in a multi-product and multi-currency environment for whom adopting the normal approach would be unduly burdensome and would not achieve the client protection objective."

From 1 December 2014 new rules and guidance will clarify that a firm that wishes to adopt the alternative approach for a particular business line must, before operating that approach, document in writing its reasons for concluding that:

- adopting the "normal approach" to client money segregation would lead to greater operational risks to the protection of client money than the alternative approach;
- adopting the alternative approach would not lead to undue operational risk to the protection of client money; and
- the firm has adequate systems and controls in order to enable it to operate the alternative approach effectively and in compliance with Principle 10 of the FCA's Principles for Businesses (which requires a firm to ensure that it has arranged adequate protection for any client assets for which it is responsible).

The firm must also notify the FCA in writing at least three months *before* it adopts the alternative approach in relation to the relevant business line and, if requested by the FCA, must provide the above analysis indicating why the alternative approach is appropriate. In addition, prior to adopting the alternative approach, the firm must provide the FCA with a written report by an independent auditor which confirms that the firm has suitable systems and controls to allow it to comply with the relevant requirements, including the calculation of any mandatory prudent segregation amount following its daily reconciliations.

A firm which operates the alternative approach in relation to any business line must review at least annually whether its reasons for adopting that approach remain valid. If the firm concludes that the reasons are no longer valid, it must cease operating the approach for that business line as soon as is reasonably practicable and in any event, within six months of the relevant review.

The new rules will also contain much more prescriptive provisions relating to reconciliations, prudent segregation and record keeping for firms that operate the alternative approach. New guidance further clarifies that although the alternative approach can, in theory, be adopted by any firm for whom it is suitable, it is most likely to be appropriate for those firms who engage in business lines involving a large number of complex transactions which are closely related to the firm's own proprietary business – i.e. typically, investment banks.

Transitional provision: a firm which is operating the alternative approach for any business line on 30 November 2014 and which has sent a confirmation to the FCA from its auditors confirming that it is able to operate that approach effectively (as required under the current rules) need not comply with the revised rules until 1 June 2015.

ACTION POINTS:

- Although the alternative approach is unlikely to be appropriate for many smaller firms, firms that wish to adopt it in the future should ensure that their reasons for doing so are clearly documented and should liaise with their auditors in order to obtain the necessary confirmation. Such firms should also note that the FCA must be notified at least three months in advance of their anticipated date of adopting the new approach.
- Firms that currently operate the alternative approach will benefit from the transitional relief, but should review their reasons for selecting that approach in relation to each relevant business line and document that reasoning – they should also ensure that if they intend to continue operating the alternative approach on and after 1 June 2015 that they will be compliant with the new rules as from then.
- All firms operating the alternative approach will need to review and revise their policies and procedures in order to take account of the new requirements.

* On 1 June 2015, the section on the alternative approach to client money segregation will move to CASS 7.13.54G to CASS 7.13.73R.

*Written agreements for title transfer collateral arrangements ("**TTCAs**") (CASS 6.1.6BR to CASS 6.1.6CG; CASS 7.2.3BR to CASS 7.2.3CG):*

The current CASS rules provide that the custody rules and client money rules do not apply to TTCAs – i.e. arrangements where a client transfers full ownership of client assets or money to a firm as collateral to secure or cover the client's present or future, actual or contingent or prospective obligations owed to that firm. In its original consultation paper, the FCA expressed concern that a lack of documented arrangements for TTCAs could lead to uncertainty, delays and disputes in the event of a failure of the firm (although it is unclear as to how many such arrangements are not currently documented in some form). As a result, from 1 December 2014, the firm must ensure that any TTCA is documented in a written agreement between the firm and the client in a durable medium. At

a minimum, the agreement must cover the following issues:

- the terms relating to the transfer of the client's full ownership of the relevant assets or money to the firm;
- any terms under which the transfer of ownership of the relevant assets or money back to the client is to take place; and
- any terms relating to the termination of the TTCA or the overall agreement.

The firm must ensure that a copy of the written agreement is retained for least five years following the termination of the TTCA.

Transitional provision: TTCAs in existence prior to 1 December 2014 do not need to comply with the above rules until 1 June 2015, unless the arrangement is materially amended on or after 1 December 2014.

Firms should note that new "switching" rules will come into force on 1 June 2015, setting out the process which firms must follow if a client requests protection under CASS for assets and monies otherwise subject to a TTCA.

ACTION POINTS:

- Firms entering into new TTCAs should ensure that these are correctly documented in written form and cover at least the minimum requirements listed above.
- Firms with existing TTCAs as of 1 December 2014 that are not already documented in written form and/or do not cover the minimum range of required issues need to begin putting in place written procedures to reflect those arrangements in preparation for the 1 June 2015 deadline.
- Such firms need to be aware that any material amendment to existing TTCAs after 1 December 2014 will mean that the transitional relief will cease to be available, so all such amendments should take place by way of a written agreement which includes all the relevant details of the TTCA.

Banking exemption: clarification and notification requirement (CASS 7.1.8AR to CASS 7.1.10CR):

The banking exemption provides that the client money rules do not apply to deposits held by a CRD credit institution or to money held by an approved bank when the money is held in an account with itself.

While the scope of the banking exemption will not be changing, from 1 December 2014 all firms that hold deposits under the banking exemption will be required to notify the client before providing any designated investment business services that the firm holds the money as banker and not as a trustee under the client money rules and therefore that if the firm were to fail, the client would not be entitled to share in any distribution under the client money distribution rules (this is broadly the same notification that approved banks which are not CRD credit institutions are currently required to make). The firm must also explain to the client the circumstances (if any) under which it would cease to hold that money under the banking exemption and would instead hold it in accordance with the client money rules.

If the credit institution or approved bank wishes to hold the relevant money as client money subject to the client money rules (rather than under the banking exemption), it must, before providing any designated investment business services to the client, disclose to the client a description of the relevant business carried on with the client in respect of which the money will be held subject to the client money rules and explain that if the firm were to fail, the client money distribution rules would apply.

Transitional provision: firms need not comply with the amended rules in respect of business relationships in existence before 1 December 2014, unless and until the terms of that relationship are materially altered on or after that date (but prior to 1 June 2015). From 1 June 2015, firms must comply with these requirements in respect of all client relationships.

ACTION POINT:

- Firms which hold money under the banking exemption should review and update their terms of business containing the requisite notification requirement, so that all new clients are given the necessary information in relation to how their money will be held and the resulting implications *prior to the firm providing its services*. They should also ensure that any pre-existing clients as of 1 December 2014 are provided with the updated terms of business before the 1 June 2015 deadline.

Disclosure requirements in relation to arrangements for the protection of client assets (CASS 9.4.1G to 9.4.4G):

Under the current rules in the FCA's Conduct of Business Sourcebook ("**COBS**"), a firm that holds client money subject to the client money rules or designated investments subject to the custody rules must provide its client with certain information in relation to how such money or assets are safeguarded (COBS 6.1.7R). The majority of these disclosure requirements only apply if the client is a retail client.

From 1 December 2014, the application of these disclosure requirements is being expanded so that firms will be required to provide this information to *any client* (however categorised) for whom they hold client money or custody assets (including any custody assets which do not fall within the definition of designated investments).

Transitional provision: firms need not comply with the above disclosure requirements in respect of an existing business relationship with a particular client that involved the provision of MiFID business or designated investment business prior to 1 December 2014, unless there is a material amendment of the terms governing that relationship on or after that date. The transitional provision expires on 1 June 2015, at which time the firm must ensure that the relevant information has been provided to the client. The information must, however, be provided in the context of all new client relationships from 1 December 2014.

ACTION POINT:

- Firms will need to revise their policies and procedures so that the relevant arrangements for safeguarding client assets are disclosed to all categories of client when the business relationship is established. This will mean that firms will have to review and update their terms of business to ensure that all new clients taken on from 1 December 2014 onwards receive the relevant notifications (and that all pre-existing clients as of 1 December 2014 are repapered by 1 June 2015 at the latest).

Written (third party) custody agreements (CASS 6.3.4AR to CASS 6.3.4BG):

The FCA is introducing a specific requirement that a firm must have entered into a written agreement with any person with whom it deposits client assets for safekeeping or with whom it arranges safeguarding and administration of client assets. The agreement must contain, at a minimum, the nature of the custody services that the third party will be providing and the binding terms of the arrangement between the parties.

Guidance on the types of issues that the FCA would expect to see addressed in such agreements includes the following:

- registration of the title to the assets in the third party's books in a manner that indicates that the relevant client assets do not belong to the firm itself;
- restrictions over the circumstances in which the third party may withdraw assets from the relevant account;
- procedures relating to the receipt of dividends, interest payments and other entitlements belonging to the client of the firm; and
- provisions governing the third party's liability for the loss of any client asset held in custody as a result of fraud, wilful default or negligence of the third party or an agent appointed by him.

Transitional provision: This requirement will apply to any new agreements concluded on or after 1 December 2014. Any non-compliant pre-existing agreements as at that date must be made compliant by the earlier of 1 June 2015 or the date of any material amendment to those agreements.

ACTION POINT:

- In many cases, firms are already likely to have put in place written custody agreements dealing with the issues set out above. However, it is worth reviewing existing terms to ensure that they make the requisite disclosures. It is also possible that in certain contexts (for example, in relation to certain intra-group arrangements) no written agreement may be place, in which case firms will need to take steps to document such agreements fully.

DvP exclusion for commercial settlement systems (CASS 6.1.12R to CASS 6.1.12ER; CASS 7.2.8AG to CASS 7.2.8AER):

From 1 December 2014, the FCA is introducing a number of amendments to the existing exemption from the custody rules and client money rules in connection with delivery versus payment ("**DvP**") transactions effected through commercial settlement systems.

The main effect of these amendments will be to introduce a specific definition of a "commercial settlement system" which may be narrower than some firms' previous understanding of the term and to require firms to be a direct member or participant or a sponsored member of such systems. The amendments will also clarify the timing of the DvP window during which the firm may benefit from the exemption.

A new rule will also introduce a requirement for the firm to obtain a client's prior written consent to the use of the DvP exemption.

Further detail on these changes is available in our earlier client briefing (*'CASS: the DvP exemption: changes from 1 December 2014')* published in July 2014, which is available at http://www.traverssmith.com/media/1428849/cassthedvpexemption.pdf.

Transitional provision: Any firms which do not meet the new and clarified criteria but which wish to continue relying on the

exemption will need to ensure that new arrangements are in place from 1 December 2014 in relation to new clients. Although there is transitional relief for existing client relationships until 1 June 2015, in practice many firms are likely to find it easier to use one set of DvP arrangements for both new and existing clients from 1 December 2014.

ACTION POINT:

- Firms that are currently relying on the DvP exemption should ensure that they are eligible to do so as direct members or participants or sponsored members of a commercial settlement system (as defined).
- If firms do not meet the eligibility criteria for the DvP exemption, they will either need to put in place policies and procedures to facilitate compliance with the relevant client money and/or custody rules or will need to restructure their arrangements in order to avoid holding client money or assets.

Non-standard client money reconciliation (CASS 7.6.6AR to CASS 7.6.6BG):*

The current requirements as regards the use of the non-standard method of internal client money segregation are set out in CASS 7.6.7R and CASS 7.6.8R. As of 1 December, these rules will be amended and clarified (in CASS 7.6.6AR) to provide that:

- Before using a non-standard method of internal client money reconciliation, a firm must:
  - establish and document its reasons for concluding that the method of internal client money reconciliation it proposes to use will:
    - for the normal approach, check whether the amount of client money recorded in the firm's records as being segregated in client bank accounts meets the firm's obligation to its clients under the client money rules on a daily basis; or
    - for the alternative approach, calculate the amount of client money to be segregated in client bank accounts which meets the firm's obligations to its clients under the client money rules on a daily basis;
  - notify the FCA of its intentions to use a non-standard method of internal client money reconciliation;
  - send a written report to the FCA prepared by an independent auditor of the firm in line with a reasonable assurance engagement (see below) and stating that:
    - The method of internal client money reconciliation which the firm will use is suitably designed to enable it to (as applicable):
      - (for the normal approach to segregating client money) check whether the amount of client money recorded in the firm's records as being segregated in client bank accounts meets the firm's obligation to clients under the client money rules on a daily basis;
      - (for the alternative approach to segregating client money) calculate the amount of client money to be segregated in client bank accounts which meets the firm's obligations to its client under the client money rules on a daily basis; and
      - The firm's systems and controls are suitably designed to enable it to carry out the method of internal client money reconciliation the firm will use;
- material changes (not defined) to a firm's non-standard method of internal client money reconciliation will oblige the firm to repeat the steps under the rules to use that method – i.e. to carry out a new assessment and obtain and provide a new auditor's report to the FCA – i.e. before materially changing its method a firm must:
  - have established and documented in writing its reasons for concluding that the changed methodology will meet the relevant requirements; and
  - obtain and send to the FCA a new auditor's report in respect of the proposed changes.

Transitional provisions: The new requirements come into force on 1 December 2014. However, firms operating a non-standard method of internal client money reconciliation as of 30 November 2014 will have until 1 June 2015 – or the date they materially alter their method of internal client money reconciliation, whichever is earlier - to comply with these new requirements.

ACTION POINT:

- Firms should ensure that their systems and controls are suitably designed to enable them to carry out the relevant method of internal client money reconciliation they have elected to use.

* On 1 June 2015, the provisions in CASS 7.6 on records, accounts and reconciliations, will migrate into a new Chapter 7.15.

Auditor assurances (alternative approach to client money segregation/non-standard method of internal client money reconciliation) (CASS 7.4.17ER and CASS 7.6.6AR):

Firms that operate an alternative approach to client money segregation (and/or a non-standard method of internal client money reconciliation) will be required to obtain, before carrying out the proposed approach/method, an auditor's report prepared on the basis of a "reasonable assurance engagement" (as defined in the Glossary).

As part of that process, the auditor will be required to opine on whether the proposed approach/method is "suitably designed" and whether it would achieve the desired regulatory outcome – e.g. an appropriate internal client money reconciliation or correct calculation of the alternative approach mandatory prudent segregation amount.

Transitional provision: Those firms that on 30 November 2014 are operating the alternative approach to client money segregation (having previously sent a written confirmation to the FCA as required by the existing rules) and/or the non-standard method of internal client money reconciliation will have until 1 June 2015 to comply with the new rules. However, any firm that materially alters its non-standard method of internal client money reconciliation will have to comply with the new rules.

ACTION POINTS:

- Any firms operating the alternative approach to client money segregation or the non-standard method of internal client money reconciliation should review their current procedures and ensure that they are compliant as from 1 December 2014 (or 1 June 2015 if relying on the transitional provision).

- In particular, firms may need to focus on the auditor's report they have, or are seeking, to ensure that it is prepared on the basis of a reasonable assurance arrangement (the FCA had received feedback during the consultation process from the audit profession to the effect that, without seeing a method of reconciliation in operation, auditors might not be able to provide the level of assurance proposed).

Reminder of amendments that have been in force since 1 July 2014

We set out below a reminder of some of the amendments that were included in the first phase of the FCA's amendments to CASS and which came into force on 1 July 2014. Firms should obviously be complying with these new rules and guidance; if this is not the case, they should take immediate steps to rectify the situation.

Clarifications on payment of interest on client money:

- The revised rules make it clear that where a firm will not pay all interest earned on client money to a retail client, the client must be notified of this in writing.

- The timing of payment of interest to any type of client may be modified by the firm's agreement with the client, but if the agreement is silent then the normal rules on allocation of client money receipts will apply.

Unbreakable term deposits:

- Since 1 July 2014, firms (except firms holding client money in their capacity as trustee firms) have been prohibited from placing client money in deposits with an unbreakable term of over 30 days.

- The prohibition on the use of such unbreakable term deposits does not prevent a firm from placing money in deposits where a withdrawal is permitted before the expiry of a fixed term or notice period (even if that term or notice period is longer than 30 days), even though such withdrawal may result in a penalty charge.

- Arrangements pre-existing 1 July 2014 which do not comply with these requirements must be replaced with compliant arrangements as soon as the firm is permitted to do so.

Right to use arrangements:

- The FCA introduced new guidance clarifying its expectations in relation to securities financing transactions (e.g. securities lending, repos or buy-sell back / sell-buy back arrangements) that firms enter into on behalf of retail clients in connection with custody assets held by the firm on behalf of such clients.

- In particular, the FCA has signalled its expectation that firms only use right to use arrangements in the context of securities financing transactions and should not otherwise use a retail client's safe custody investments. It also emphasised that the firm must have regard to the client's best interests rule and must ensure that collateral arrangements meet certain criteria when entering into such transactions, including daily monitoring of realisable values and the firm making up the difference for any shortfall in the current realisable value of collateral, unless otherwise agreed with the client.

- Any client documentation which is contrary to this guidance – for instance, by still purporting to take a "blanket" right of use – should be amended.

For further information on any of the issues discussed above, please contact any of the financial services partners named below.

Travers Smith LLP
10 Snow Hill
London EC1A 2AL

T +44 (0)20 7295 3000
F +44 (0)20 7295 3500

Jane Tuckley
jane.tuckley@traverssmith.com
+44 (0)20 7295 3238

Mark Evans
mark.evans@traverssmith.com
+44 (0)20 7295 3351

Phil Bartram
phil.bartram@traverssmith.com
+44 (0)20 7295 3437

Margaret Chamberlain
margaret.chamberlain@traverssmith.com
+44 (0)20 7295 3233

Tim Lewis
tim.lewis@traverssmith.com
+44 (0)20 7295 3321