

Financial Services and Markets

Custody liens: an update

On 20 January 2012 the FSA published [PS 12/2 Client assets sourcebook: custody liens](#) alongside its amendments to the rules regarding liens and other rights in custody agreements that will come into force on 1 April 2012. The amended rules will extend the scope of the limited exceptions to the general restriction against such liens and rights to those arising under omnibus agreements. In addition, transitional relief means that firms will now have until 30 September 2012 (rather than 31 March 2012) to ensure that their existing agreements (i.e. those executed before 1 April 2012) are compliant.

Background

The FSA originally consulted on, what it has called "inappropriate liens" over custody assets, in CP10/9: *Enhancing the Client Assets sourcebook* in March 2010 and made rule changes in October 2010 (with the rules to come into force on 1 October 2011).

A new rule, in CASS 6.3.5R, would provide that where a firm deposits safe custody assets belonging to a client with a third party, the firm must ensure that the agreement does not include the grant to that third party, or to any other person, of a lien or right or retention or sale over the safe custody assets, or a right of set-off over any client money derived from those safe custody assets (the "general lien restriction").

However, there would be specified exceptions from the general lien restriction. These exceptions, in CASS 6.3.6R, would be for liens or rights to secure properly incurred charges and liabilities arising from the provision of custody services *to a client*, liens or rights required by securities depositaries, securities settlement systems and central counterparties to facilitate settlement of a *client's* trades and liens or rights over assets or money held in overseas jurisdictions as a result of local law or as a *necessary precondition* for participation in a local market provided that the firm has taken reasonable steps to determine that holding those assets or that money subject to such a lien or right is in the best interests of the client.

Industry concerns

Concerns were raised by the industry with regards to liens over assets held in omnibus accounts (i.e. accounts in which clients' assets were pooled). It was pointed out that the proposed exceptions (as outlined above) would only be available in relation to liens and other rights granted in relation to a *specific client's assets* (and associated client money) and would not contemplate or allow for the fact that, in practice, clients' assets are generally held by firms in omnibus (i.e. pooled) accounts with custodians and that omnibus accounts are opened at securities depositaries, in securities settlement systems and at central depositaries.

Concerns were also raised with regards to the exception in relation to overseas jurisdictions: it was argued that the "necessary precondition" limb (i.e. that a firm would have to show that the relevant lien or right was a *necessary precondition* for participation in a local market) might be too strict, since if one firm were able to remove a lien from its agreement (e.g. due to its bargaining power), any other firms who failed to do (perhaps because of less bargaining power due to smaller market strength) might not be able to rely on the exception.

In the light of these concerns, the FSA consulted again (in CP11/15: *Client Assets sourcebook*) (July 2011) proposing an interim delay to the new rules and consulting on further rule changes to take account of industry concerns. The rules (which were to come into force on 1 October 2011) were effectively "switched off" until 1 April 2012, by transitional relief which applied from 1 October 2011 to 31 March 2012.

The FSA's revised rules

Under the FSA's revised rules, the scope of the exceptions from the general lien restriction has been widened and, while the new rules will come into force on 1 April 2012 as before, there is some additional transitional relief for firms as regards pre-existing documentation.

Under CASS 6.3.6R as redrafted, the exceptions will now permit liens and other rights over safe custody assets in favour of a third party or another person instructed by that party to provide custody services (e.g. a sub-custodian) where that lien or right:

- is restricted to those safe custody assets *held in an account* with that third party or that other person and extends only to properly incurred charges and liabilities arising from the provision of custody services in respect of safe custody assets *held in that account*;
- arises under the operating terms of a securities depository, securities settlement system or central counterparty *in whose account* safe custody assets are recorded or held for the purpose of facilitating the settlement of trades *involving assets held in that account*;
- arises in relation to those safe custody assets held outside the UK provided they do so as a result of local applicable law in that jurisdiction or it is *necessary for that firm* to gain access to the local market in that jurisdiction and, in respect of each client to whose those assets belong, either the firm has taken reasonable steps to determine that holding those assets subject to the lien or right is in the best interests of the client or, *where the client is a professional client, the firm is instructed by that client to hold those assets in that jurisdiction notwithstanding the existence of the lien or right.* (Additional guidance, in CASS 6.3.7G will indicate when a firm will be considered to be acting on the instructions of its professional client – broadly speaking, prior to acting on the client's instruction, the firm must have informed the client that holding its assets in the relevant jurisdiction will involve the granting of a lien or right.)

The revised rules also make it clear that the exceptions in CASS 6.3.6R do **not** permit a firm to agree to a right of set-off prohibited by CASS 7.8.1R (notification and acknowledgement of trust: where a firm opens a client bank account) and CASS 7.8.2R (notification and acknowledgement of trust: where a firm undertakes any contingent liability investment for clients through an exchange, clearing house, intermediate broker or OTC counterparty).

When the rules come into force and transitional relief

Under the amended rules the position is now as follows:

- **Agreements executed on or after 1 April 2012:** The rules regarding inappropriate liens, amended as outlined above, come into force on **1 April 2012**. The general prohibition, and the amended exceptions to it, will therefore apply to all **new** agreements entered into on or after that date.
- **Agreements executed before 1 April 2012:** There is transitional relief **until 30 September 2012**. However, guidance states that firms should modify such agreements "*as soon as reasonably practicable*" so as to meet the requirements.

In the light of this, in addition to being prepared to ensure that all new agreements entered into on or after 1 April 2012 comply with the rules, firms should also now be checking all existing relevant custody documentation in relation to clients' safe custody assets. They should ensure that any liens or similar interests and/or rights of set off granted under such agreements **are either removed or are otherwise limited to fall within one of the exceptions in CASS 6.3.6R as soon as reasonably practicable and in any event by 30 September 2012 at the latest.**

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