MiFID 2: Changes to Client Assets Requirements

This article looks at changes MiFID 2 will make to how investment firms protect client money and assets

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Introduction

Previous articles in our MiFID 2 series have considered the effects of MiFID 2 on, among other things, dealings with customers, advice, transparency, and compliance. This article, by Tom Harkus, looks at how MiFID 2 will affect the safeguarding of client assets.

With the exception of an outright ban on the use of title transfer collateral arrangements (TTCAs) for retail clients, the MiFID 2 package does not change the fundamental principles of the client assets regime laid out in the Directive it is replacing (MiFID).

MiFID

Currently, under MiFID, where client assets are deposited with a firm that is subject to MiFID those assets are generally afforded client money protection. The exceptions to this rule are (i) where those assets are transferred on a title transfer basis, (ii) where funds are held by a credit institution (known in the UK as the banker's exemption), or (iii) for financial instruments if the client has expressly opted out.

Member States implemented MiFID through local laws and regulations, as it is a Directive that therefore requires local measures to apply it. The high-level standards set by MiFID required firms, in relation to MiFID business, to make "make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency" and "to prevent the use of a client's instruments on own account". These were subject to the title transfer and bankers exceptions as set out above.

MiFID 2

MiFID 2 retains the basic principles of MiFID but adds a layer of detail and specific obligations. In summary these are:

- an outright ban on TTCAs with retail clients (as is already the case in the UK);
- additional obligations, including suitability assessments, for TTCAs with professional clients;
- additional requirements on securities financing arrangements;
- diversification requirements on assets deposited with third parties and restrictions on security interests over such assets;
- the tightening of a firm's ability to use alternative measures instead of asset segregation where client money is held in a third country jurisdiction;
- additional information and record keeping requirements, principally for the benefit of insolvency practitioners; and
- the requirement to appoint a single officer responsible for client assets.

The UK's position

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Despite the fact that Member States were not supposed to "gold-plate" MiFID when implementing it (i.e. adding additional requirements), over time the Financial Services Authority (as it was then) and the Financial Conduct Authority (the FCA) have already implemented many MiFID 2 requirements by updating the rules in the Client Assets Sourcebook (CASS) within the FCA's handbook. In particular they have introduced greater restrictions on the exemptions. Aside from the bankers' exemption, it is now not possible in the United Kingdom for retail clients to opt out or use TTCAs in relation to MiFID business with MiFID firms.

Timing

At present, EU Member States have until 3 January 2017 to implement these changes. There are various technical standards which the European Markets Securities Authority (ESMA) are required to submit to the Commission for adoption. As previous articles in this series have discussed, several of these were submitted later than expected. There is currently a political will by the European Commission (the Commission) to delay the implementation of MiFID 2 in its entirety for at least one year and possibly longer, although it is possible there may be a delay only to the effective date of certain parts – particularly as the ability of firms to prepare to comply with some parts of MiFID 2 depends on measures taken in relation to other parts. We would suggest that if the delay is implemented in stages, there is no reason to delay application of the client assets rules, given the fact that the United Kingdom is evidence that it is possible to comply now without the other strands of MiFID 2 being in force. See further our **article in WSLR December 2015**.

Article 16(12) of MiFID 2 allows (but does not require) the Commission to adopt delegated legislation which would "specify the concrete organisational requirements" of the safeguarding of client assets set out in Article 16(2) to (10) of MiFID 2. The Commission asked ESMA to consider certain parts of Article 16, and ESMA did so, including a discussion of key points in its Technical Advice to the Commission published on 19 December 2014 (see further our **article in WSLR January 2015**.

As we have noted in previous articles, the Commission has not yet published the delegated legislation, so we do not know whether it will adopt ESMA's suggestions. In the rest of this article we look at some of the specific amendments in more detail, focusing on issues firms will have to address when trying to meet the new requirements – or may do if the delegated legislation looks as ESMA suggests.

Title Transfer

Under MiFID, no client was restricted from providing assets as collateral on a title transfer basis. MiFID 2 prohibits retail clients from transferring assets on a title transfer basis without exception. For professional clients it is still permitted but ESMA has suggested a number of restrictions and additional obligations on firms. Given Article 16(10) of MiFID 2 refers only to retail clients, some market participants have expressed their disagreement with these provisions, claiming that ESMA has overstepped the mandate the Commission gave it. The Commission's mandate merely asked for advice on (among other things) "measures to ensure an appropriate use of TTCA when dealing with non-retail clients".

The restrictions include the an obligation to assess "appropriateness" of TTCAs for professional clients. ESMA clarifies "appropriateness" does not have the same meaning as applies when selling investments to clients (and the application of the relevant suitability or appropriateness test in that context). Instead, here "appropriateness" means that the firm can "demonstrate a robust link between the TTCA and the client's liability". Clearly this will entail additional cost and process for MiFID firms. ESMA's advice is that TTCAs are not appropriate where:

- there is only a very weak connection between the client's obligation to the firm and the TTCA (including where the likelihood of a liability is low or negligible);
- the amount of client funds or financial instruments subject to TTCAs far exceeds the client's liability, or is completely unlimited;
- firms insist that all client assets must be subject to TTCAs as a matter of policy, without considering what obligation each client has to the firm.

Some of these are market practice at present. For example clearing members of central counterparties often have the ability to call for much larger amounts of collateral than is requested from the central counterparty. Firms that adopt these practices will need to review their documentation before MiFID 2 comes into force. Whilst credit institutions can still use the bankers' exemption, we have seen the development of products at central counterparties, such as client accounts that allow the posting of margin that is subject to client money protection.

ESMA stresses in the advice that investment firms should consider and be able to show they have properly considered using a TTCA in the context of the relationship between the client's obligation to the firm and the client assets the firm subjects to TTCA. It also highlights the need for disclosure, so firms tell clients about the risks involved and the effect of any TTCA on the client's assets.

So it is clear ESMA wants to see the Commission make firms take a client-by-client view, and use TTCAs only where the nature of the relationship and obligations between client and firm make it appropriate to do so. Firms that wish to continue using TTCAs need to be prepared to review their policies and potentially use fewer than they currently do. It further stresses that nothing in the existing MiFID Implementing Directive (which parts of its advice recommend the Commission amends) should allow TTCAs to be used in relation to retail clients. Respondents to ESMA's consultation had asked it to state explicitly that securities lending transactions would not be TTCAs but ESMA has not done so.

However, it did note that perhaps the MiFID Implementing Directive could be amended to clarify that client consent is needed for the use of client financial instruments by any person at all.

Securities Financing

Most firms already take collateral to cover securities financing transactions, but in response to ESMA's consultation thought it unnecessary to require this for non-retail clients. Respondents were also concerned about the overlap with other EU laws, particularly the Securities Financing Transactions Regulation (the SFTR), which came into force on 12 January 2016. Unless a securities financing transaction can be done in a way that is not a TTCA, it is subject to the rules under MiFID 2 in addition to those under the SFTR. ESMA acknowledged this but said MiFID 2 was the appropriate place to house legislation on collateralisation of SFTs.

ESMA suggested, and respondents approved, the need to record client consent, which can be done in any manner permitted by national law, and can be given at the outset of the client relationship so long as what the client is consenting to is clear. ESMA's advice also suggests firms should have specific arrangements for retail and non-retail clients to ensure the borrower of client assets provides the appropriate collateral, and that the firm monitors the appropriateness of the collateral and takes any steps necessary to keep the balance with the value of client assets.

Depositing client assets with third parties

Firms who deposit client funds with third parties must consider the diversification of these funds as part of their due diligence and the arrangements for holding the funds. There are not guidelines or set percentages (other than for intragroup deposits) and there is a carve out for funds transferred for specific transactions. It is also important to note this does not apply to credit institutions for deposits they hold.

There is a limit of 20% where funds are deposited with a group entity, which ESMA took forward despite opposition. This does not apply where such entity is a credit institution. Helpfully, there is also a carve out where it is not proportionate in view of the nature, scale and complexity of the firm’s business and the protections offered by the intragroup entity holding the funds. These rules only apply to funds (i.e client money) and not other financial instruments.

Firms cannot have inappropriate security interests, liens or rights of set-off over client assets such that they allow a third party to dispose of the assets to recover debts that are unrelated to the clients. Such rights are only considered “appropriate” where they are required by applicable law in a third country jurisdiction. If a firm goes down this route, it must disclose this to its clients so they know the associated risks. Firms must also record in client contracts and its own accounts the ownership status of any assets subject to a relevant grant.

Segregation of assets

Segregation of client assets is part of using "adequate arrangements" to safeguard the rights of clients. However, firms may use "other equivalent measures" as an alternative to segregating assets, when they cannot comply with segregation requirements in third country jurisdictions due to reasons of applicable law. ESMA's advice is that in these cases, Member States should specify what the "other equivalent measures" should be – and again, firms should make a specific disclosure to clients so the client knows it will not have the protections MiFID 2 envisages. ESMA thinks risk warnings should be tailored to the client so they address the specific risks the client is exposed to.

Oversight

There is currently no requirement for a specific officer responsible for safeguarding of client assets. But that is exactly what MiFID II imposes on firms as part of its governance arrangements. A single officer should be responsible for matters relating to the safeguarding of client instruments and funds. Whether that person is dedicated or not has been left to firms to decide. However, ESMA ha made it clear that it expects larger firms to have a dedicated individual whereas it acknowledges that the individual in smaller firms may have other responsibilities. It will be a difficult decision to make for firms that aren’t obviously large or small. For those medium-sized firms it is a question of judgment, and whether that person has the time and resources required to discharge all of his or her functions.

Preventing unauthorised use of client financial instruments

ESMA's advice also covers measures firms should take to prevent unauthorised use of client money, and says the measures can include:

- entering into agreements with clients on measures the firm will take if the client does not have enough in its account on settlement date – such as borrowing securities on the client's behalf or unwinding the position;

- the firm closely monitoring whether it is likely to be able to deliver on the settlement date and putting in place remedial measures if it needs to; and
- close monitoring and prompt requesting of undelivered securities outstanding on the settlement day and beyond.

ESMA stresses these provisions relate to unauthorised use, do not prevent firms from using omnibus accounts and does not contradict the Central Securities Depositories Regulation.

Record Keeping

Firms will be subject to additional information and record keeping requirements in such a way that they may be used as audit trail. This is mainly for the benefit of for insolvency practitioners and relevant authorities in the event that the firm becomes insolvent. This includes (where relevant):

- accounts which readily identify the balances of funds and instruments of each client;
- details of the accounts where funds and financial instruments are held and the agreements under which those assets are held;
- details of third parties carrying out outsourced or delegated tasks; and
- key individuals of the firm involved in safeguarding client assets, including those responsible for oversight of compliance with the client asset rules.

Impact on firms

The impact on firms will vary from Member State to Member State. For the UK, most of this is already part of the FCA's rules so it will have a limited impact. FCA's next consultation paper should address any necessary changes, but it cannot sure of what it needs to do until the Commission adopts the delegated legislation. That said, the requirement to assess whether TTCAs are suitable for professional clients is one area which will impact all firms significantly. It is not just a case of updating processes, but its documents and arrangements may need to be amended, for example where firms have the right to call for unlimited or disproportionately high amounts of collateral compared to their client's liabilities. They may need to split such arrangements to the "proportionate" amount is subject to a TTCA and any additional collateral is held as client assets and provided the relevant protections. We may also see a reluctance to deal with firms that satisfy the professional client requirements as if they are retail clients, which has been common practice under the current MiFID. The other requirements will generally mean additional costs, and these will inevitably be passed down to the clients the rules are designed to protect.

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