2014 EFMLG Initiative on Collateral

European laws or Initiatives that impact on collateral management

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Executive summary

The purpose of the current paper is to concisely analyse and explain the different issues affecting collateral on the basis of the following list, covering the areas of: (i) Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR), (ii) Regulation (EU) No 648/2912 on OTC derivatives, central counterparties and trade repositories (EMIR), (iii) draft regulatory technical standard (RTS) on risk-mitigation techniques for OTC-derivatives contracts not cleared by a CCP of 14 April 2014 (JC/CP/2014/03) plus corrigendum of 14 May 2014, (iv) Directive 2014/65/EU on markets in financial instruments (MiFID II) in combination with the Regulation (EU) No 600/2014 on markets in financial instruments (MIFIR) and ESMA Discussion Paper on MiFID II and MiFIR of 22 May 2014 (ESMA/2014/548), (v) the draft regulation on reporting and transparency of securities financing transactions of 29 January 2014 (COM 2014), (vi) the draft regulation on structural measures improving the resilience of EU credit institutions of 29 January 2014 (COM(2014) 43 final) (Liikanen), (vii) the joint discussion paper of ECB and Bank of England on the case for a better functioning securitization market in the European Union of May 2014 and (viii) the IOSCO Recommendations Regarding the Protection of Client Assets of 29 January 2014.

A - CRR

B - EMIR

A. Cash Collateral

1. Both Article 224 CRR[1] and the draft RTS margin rules for non-cleared OTC derivatives[2] (the "Draft EU RTS") envisage a haircut of 8% for currency mismatches i.e. where the collateral currency is different from the currency of the trade.

The envisaged 8% haircut will be symmetrical if one party funds in U.S. dollars (USD) and the other in EUR. Note should also be taken of the market proportion of interest rate swaps denominated in USD, cross-currency swaps where one leg is in USD or other multi-currency derivative trades (e.g. non-deliverable forwards, fx derivatives, commodity derivatives, equity derivatives, with cash and physical delivery) where settlement is in the USD. An 8% haircut in these circumstances for an EU bank funding in EUR implies it over-collateralising substantially and undertaking a material number of FX trades just to implement, finance and/or hedge the haircuts.

Further under the Draft Proposed Rule for Margin for Uncleared Swap from the U.S. Prudential Regulators (the "Draft US Proposal")[3], eligible collateral for variation margin (VM) would be limited to USD or the currency of the trade. Haircuts are always envisaged if the cash collateral is not in USD or currency of trade.

In the light of the above and in particular in view of the preference given by the Draft US Proposal to its currency, namely no haircuts if USD is cash collateral irrespective of the currency of the trade, we urge the Commission to consider a similar rule for the EU, namely no haircut if the cash collateral is in EUR or the currency of the trade.

B. Securities collateral

We understand that unlike the Draft EU RTS, the Draft US Proposal does not have the equivalent with regard to the credit quality risk requirements set out on pages 34 to 39 of

[1] Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR), Article 224 (Supervisory volatility adjustment under the Financial Collateral Comprehensive Method).

[2] Consultation Paper (the "Consultation Paper") on the Draft regulatory technical standards on risk-mitigation techniques for OTC-derivative contracts not cleared by a CCP under Art. 11(15) of Regulation (EU) No 648/2012 dated 14 April 2014.

[3] On September 3, the Board of Governors of the Federal Reserve ("Board"), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Farm Credit Administration and the Federal Housing Finance Agency (collectively, the "Prudential Regulators") voted to re-propose rules implementing Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")

the Draft EU RTS i.e. external credit ratings, volatility assessments, concentration limits and wrong way risk for securities collateral used as initial margin (IM).

We urge the Commission to also look into this so that there are no bottlenecks and/or comparative disadvantages for the European entity from dissimilar regimes.

C. Eligible Collateral for IM and VM purposes:

Whilst the Draft EU RTS envisages the same list of collateral (both cash and securities collateral) for IM and VM purposes, under the Draft US Proposal, there is a distinction between eligible cash collateral for VM and IM purposes. Only the USD and currency of trade is eligible collateral for VM purposes (i.e. securities collateral is not eligible as VM) whilst for IM purposes the collateral could be cash in a major currency (as well as certain securities collateral).

For the reasons set out in point A above, to enable a level playing field, the EU RTS on Margin should enable European banks to also post EUR (without haircuts) as cash collateral for IM and VM purposes.

C – MiFID

I. According to Article 16 (10) of MiFID II[4] *"An investment firm shall not conclude title transfer financial collateral arrangements with retail clients for the purpose of securing or covering present or future, actual or contingent or prospective obligations of clients"*. It then follows that, as MiFID II prohibits TTCA arrangements[5] for retail clients under certain conditions, there is need for the delimitation of the relevant prohibition. Furthermore, MiFID II introduces a general obligation of the firms to safeguard client financial instruments and funds[6], which is further highlighted by the Commission[7] stating that the indiscriminate use of TTCAs by investment firms would put at risk the efficacy of segregation of client assets requirements.

[4] Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) (OJ L 173 of 12.6.2014, pp. 349-496)

[5] The definition of title transfer collateral arrangements (TTCA) is included in Directive 2002/47/EC (Financial Collateral Directive (FCD) as referred to in MiFID I, Recital 27(b): *"'title transfer financial collateral arrangement' means an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations; (FCD Article 2(1)(b))"*.

[6] Article 16 (8 - 11)

[7] European Commission, Public Consultation: *Review of the Markets in Financial Instruments Directive (MiFID)*, 2010, p. 70.

Against this backdrop, ESMA[8] advises on application of TTCA, which should be subject to certain limits by determining the criteria of "inappropriateness" of using TTCA in the following cases:

(i) when there is only a particularly weak connection between the client's liability or consideration to the firm and the use of TTCA, including where the likelihood of a liability arising is low or negligible;

(ii) where the amount of client funds or financial instruments subject to TTCA far exceeds the client's liability, or is even unlimited if the client has any liability at all to the firm; or

(iii) where firms insist that all clients' assets must be subject to TTCA, without considering what obligation each client has to the firm.

ESMA also proposes the imposition on investment firms of the obligation to demonstrate the appropriateness of any TTCA used with their clients by means of the relationship between the client's obligation to the firm and the client assets subjected to TTCA by the firm.

Nonetheless, as collateral transferred might be often used by firms with the purpose of reducing the cost of funding obtained in support of client activities, the imposition of general new requirements when concluding TTCA with non-retail clients would inevitably increase the cost of credit provided to such clients.

II. In terms of application of TTCA in securities financing transactions, despite Article 19 of MiFID Implementing Directive[9] requiring retail client consent for the use of their assets by any party, by allowing some types of transactions under Article 19 of MiFID II that may require transfer of title, this could be regarded as allowing collateral arrangements with retail clients for the purpose of securing or otherwise covering present or future, actual or contingent or prospective obligations that are prohibited by Article 16(10) of MiFID II.

However, ESMA does not preclude the application of Article 19 of the MiFID Implementing Directive for retail clients, provided that securities lending arrangements are undertaken using an alternative legal mechanism. Consequently, firms should be prevented from making use of Article 19 to effect arrangements that are prohibited under Article 16(10) of MiFID II. Thus, in this way, the arrangements stipulated in Article 19 of the MiFID Implementing Directive could be safeguarded and not be prevented by application of Article 16 (10) of MiFID II. Nevertheless, a further clarification might be needed where the transfer of a financial instrument is the main obligation under an

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[8] European Securities and Markets Authority, Consultation Paper: *MiFID II/MiFIR*, 2014, p. 55.

[9] Directive 2006/73/EC implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ L 241 of 2.9.2006, pp. 26-58).

agreement and the financial instrument does not serve as a collateral and, therefore, the application of Article 16 (10) seems to be doubtful.

D – Shadow Banking

Proposed regulation on reporting and transparency of securities financing transactions of 29 January 2014 (COM (2014) 40 final) (proposed SFT Regulation)

1. Introduction – provisions on rehypothecation

The proposed SFT Regulation introduces inter alia contractual transparency requirements for rehypothecation[10]. Rehypothecation is defined broadly under the proposal as 'the use by a receiving counterparty of financial instruments received as collateral in its own name and for its own account or for the account of another counterparty.'[11] This broad definition of rehypothecation is analogous to the term 'reuse' used by the Financial Stability Board[12].

The nature of the contractual transparency requirements under the proposed SFT Regulation is to allow counterparties to have the right to rehypothecate only where: (a) the providing counterparty has been duly informed in writing by the receiving counterparty of the risks that may be involved in granting consent to rehypothecate; and (b) the providing counterparty has granted his prior express consent as evidenced by the signature of the providing counterparty to a written agreement or an equivalent alternative mechanism. Moreover, counterparties shall exercise their right to rehypothecation only where: (a) rehypothecation is undertaken in accordance with the terms of the written agreement referred to above; and (b) the financial instruments received as collateral are transferred to an account opened in the name of the receiving counterparty.

2. Regulatory burden on counterparties seeking to rehypothecate

In essence, the proposal introduces three main requirements for counterparties seeking to rehypothecate:

(i) *Requirement to inform counterparties in writing of the risks involved in granting consent to rehypothecation, in particular the potential risks in the event of the default of the receiving counterparty*

This requirement implies an increased **administrative burden and costs** on the counterparties. Therefore, it needs be implemented in a way that does not introduce

10 Article 15 of the proposal.

11 Article 3(7) of the proposal.

12 Strengthening Oversight and Regulation of Shadow Banking: Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos' ('FSB Recommendations'), 29 August 2013, available on the, FSB's website at http://www.financialstabilityboard.org/.

operational frictions. For example, it could be implemented by means of a standard document as part of or as an Annex to the relevant master agreements used by the counterparties[13]. This would be necessary to minimise the costs of such transactions, to ensure the smooth functioning of securities lending and repo, to increase settlement efficiency and to minimise settlement risk.

(ii) Obtaining prior express written consent to rehypothecation

The proposal sets out that the providing counterparty must also grant its prior express consent to rehypothecation. This must be evidenced by the signature of the providing counterparty to a written agreement or equivalent alternative mechanism.

However, the proposal does not make a distinction between financial collateral transferred under a ‘title transfer financial collateral arrangement’ and ‘security financial collateral arrangement’ within the meaning of Directive 2002/47/EC[14]. Under the title transfer financial collateral arrangement, the collateral provider transfers **full ownership of, or full entitlement** to, financial collateral to a collateral taker. This is the most prevalent means of transferring financial collateral in the EU[15]. By contrast under the security transfer financial collateral arrangement the collateral provider provides financial collateral **by way of security** to or in favour of a collateral taker, and thus the full or qualified ownership of, or full entitlement to, the financial collateral remains with the collateral provider when the security right is established.

Because the proposal does not make the distinction between these two types of arrangements, this has the impact of restricting the collateral taker from enjoying full ownership or full entitlement to the financial collateral under a title transfer financial collateral arrangement: where the additional requirement for prior express consent to rehypothecation is not fulfilled, the receiving counterparty may not rehypothecate. This **undermines the nature of title transfer** arrangements and introduces **legal uncertainty** as regards the concept ‘full ownership’ of such financial collateral.

(iii) Transfer of the assets to the receiving counterparty’s own account

The requirement for the transfer of the assets to the receiving counterparty’s own account also entails an additional administrative burden and associated costs. However, it is

[13] The relevant master agreements include the Global Master Repurchase Agreement (GMRA 2011), the Global Master Securities Lending Agreement (GMSLA) and the European Master Agreement (EMA 2004).

[14] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (OJ L 168, 27.06.2002, p. 43).

[15] For example, under the GMRA 2011. See FSB, Securities Lending and Repos: Market Overview and Financial Stability Issues, Interim Report, 27 April 2012, pages 20 and 25; see also Thomas Keijser, Financial Collateral Arrangements, Kluwer 2006, page 93.

acknowledged that such rules are consistent with existing market practice in major securities markets in the EU (e.g. rehypothecation undertaken by prime brokers based in the UK), particularly in the wake of the financial crisis[16]. Therefore, this aspect of the proposal will not have a significant impact on collateral.

3. Risks for chains of collateral that have been rehypothecated

If a counterparty fails to fulfil any of the above requirements relating to rehypothection, this could result in risks for chains of collateral, where failure to comply with the requirements of Article 15 affects the validity of the terms of a SFT or the possibility of the parties to enforce the terms of a SFT[17].

E – Commission draft Regulation on structural measures

1. The proposal.

On 29 January 2014, the Commission published a proposal for a Regulation on structural measures improving the resilience of EU credit institution (the proposal). The proposal was the anticipated follow-up to the so-called Liikanen Report. It contains two main building blocks – the prohibition of proprietary trading and the potential separation of some other trading activities.

First for the covered institutions (see below the scope of application), the proposal suggests (Article 6) a **ban on narrowly defined proprietary trading** where desks, units, divisions or individual traders specifically dedicated to taking positions for making a profit for own account, without any connection to customer activity or hedging the entity's risk would be prohibited. The proposal (Article 9) moreover provides for **separation of certain risky trading activities**, i.e. all activities which are not traditional banking operations (traditional banking operations are, e.g. deposit-taking, money brokering and payment services and trading in EU sovereign debt), subject to supervisory approval. The proposal also allows for the exemption of certain trading activities related to managing both specific own and client risks.

The proposal presumes **separation would be required once certain metric thresholds relating to trading activities are exceeded** (e.g. size, leverage, complexity, profitability, market and counterparty risk, and interconnectedness), **<u>unless</u>** supervisors assess this is not justified. The burden of proof to establish that the activities do not pose systemic risks and that separation is therefore not justified, lies with the credit institution. In addition, supervisors will have the discretion to also separate activities even if the thresholds are

16 Commission Impact Assessment, Annexes 5 - 14 accompanying the proposal for a Regulation of the European Parliament and of the Council on reporting and transparency of securities financing transactions, 29 January 2011, p. 277.

17 Article 20(5) of the proposal *a contrario*.

not met. In order to ensure that the separation is effective and the entities remain legally, economically and operationally separate, the **separated entities will be subject to strict rules** regarding cross directorship and cross ownership restrictions, separate funding arrangements, contracts and transactions on arm's length basis, publicly distinct names and stricter intra-group large exposure limits.

2. Scope of application.

The Commission proposal expressly aims at dealing with the 'too big to fail' and 'too interconnected to fail' issue. By doing so, it applies only to EU banks deemed to be of global systemic importance or to those exceeding certain thresholds: €30 billion in total assets, and trading activities either exceeding €70 billion or 10 per cent of the bank's total assets (Article 3). The methodology for the calculation of trading activities, in order to determine the scope of application of the regulation, is contained in Article 23. According to that disposition, in 'trading activities' are included trading securities assets and liabilities, and derivative assets and liabilities. Trading assets and liabilities are defined respectively as assets and liabilities 'that are part of a portfolio managed as a whole and for which there is evidence of a recent actual pattern of short-term profit taking[18]'. Derivative assets and liabilities must not be identified as hedging instruments. The terms of the calculations will be specified by EBA/Commission technical standards; Commission is then empowered to amend the components of trading activities. Even the definitions seem to exclude assets used as financial collateral, it will have to be verified if they will not fall, in the end, in the scope of application. This may present the institutions with a trade-off. Certain collateral that institutions hold may count towards the trading activities as defined in article 23, which may contribute to these institutions falling within the scope of the proposal, with all consequence stemming from that.

3. Prohibition of proprietary trading and collateral.

As already noticed, Article 6 lays down a general ban on proprietary trading. In particular, it is prohibited, for the covered credit institutions, to engage in proprietary trading and to invest in alternative investment funds, for the sole purpose of making a profit for own account. Proprietary trading is defined in Article 5(1)(4) a 'using own capital or borrowed money to take positions in any type of transaction to purchase, sell or otherwise acquire or dispose of any financial instrument or commodities for the sole purpose of making a profit for own account, and without any connection to actual or anticipated client activity or for the purpose of hedging the entity's risk as result of actual or anticipated client activity, through the use of desks, units, divisions or individual traders specifically dedicated to

[18] Moreover, the definition of trading securities liabilities requires that they are take 'with the intent of repurchasing in the near term'.

such position taking and profit making, including through dedicated web-based proprietary trading platforms'. It must be noted that the definition is intended to be self-sufficient and the proposal does not foresee its further specification in a Level 2 legal act.. The prohibition is general on a group level; this means that not only the core credit institution, but any other entity of the banking group (including trading entities) cannot carry out proprietary trading, as defined by the draft regulation.

The definition of proprietary trading appears quite narrow; this is the exact intention of the Commission[19] in order to avoid any confusion with market making activities (which might be clear in theory, but very opaque in practice). In particular, proprietary trading should display the characterizing elements of the 'sole purpose of making a profit for own account' and of the 'competence' of specific desks, units and division.

The difference between proprietary trading and market-making is very relevant, under the regulation. As seen above, proprietary trading is totally banned for every entity of the group, while market making might be separated with all the other trading activities (which are not defined in the draft regulation) from the credit institution. In the latter case, the separated activities could be carried out by a trading entity within the perimeter of the group. Conditions are provided to ensure a strong separation in legal, economic, governance and operational terms between the trading entity and the deposit taking-entity. After the separation, trading entity may not take deposit and provide retail payment services.

In theory, the core credit institution and the trading entity can receive and use cash and financial instruments as a collateral to reduce risk of their respective activities. This is clearly provided for the trading entity in the draft regulation. Article 20 states that the trading entity shall not '(a) take deposits that are eligible under the Deposit Guarantee Scheme in accordance with Directive 94/19/EC *except where the said deposit relates to the exchange of collateral relating to trading activities*'. Equally, the deposit taking entity/ core credit institution should be allowed to the collateral management activity, with regards to the traditional core activity carried out (in particular, with the purpose to reduce credit risk).

Nevertheless, both the core credit institution and the trading entity are prohibited from proprietary trading; moreover, a credit institution, which has been subject to separation, can only carry out trading activities in the trading entity. Prohibition of proprietary trading, as seen above, is general and all-embracing. This might lead to a very burdensome limitation to collateral management for credit institutions, widely reducing the possibility to use assets as collateral. In addition where an institution has been separated, the core

19 See Recital 16.

credit institution may have to transfer to the trading entity some assets that they could have used as collateral. The outcome might create difficulties for the core credit institution to take part in refinancing operations. This outcome might affect liquidity and soundness of the credit institutions, and be an obstacle in the road for the strengthening of the financial system after the crisis.

The proposal attempts to mitigate some of these undesired effects, by providing in Article 6, for exceptions to the general ban of proprietary trading. Article 6(2) states the prohibition shall not apply to financial instruments issued by Member States central governments or other public entities and proprietary trading carried out in the cash management process. In this case the exception is granted if the credit institution exclusively holds, purchases sells or otherwise acquires or disposes of cash or cash equivalent assets (as defined by the same regulation[20]).

Exceptions are provided even when trading activities other than proprietary trading have been separated with a supervisory decision. Article 11 allows core credit institutions carry out trading activities 'to the extent that the purpose is limited to only prudently managing its capital, liquidity and funding', upon strict criteria[21]. Article 12 permits provision of services of risk management for clients, again with strict requirements.

These provisions are arguably aimed at granting the core credit institutions some rooms for managing their own risk using collateral, even under the limitations of the proposal on structural measures. Nevertheless, it seems that, given the requirements set in the draft regulation, the latter might have a restrictive effect., It has to be assessed whether the exception to the prohibition on proprietary trading for cash management processes will not have a restrictive effect on management of liquidity and will make more difficult for the credit institutions to respect the related requirements. At the same time, the list of instruments for which trading is admitted, for covered institutions, seems very narrower than the list of eligible collateral for central banking operations. Even if both the credit institution and the trading entity will be deemed as eligible counterparties for these kind of operations, it is possible that the prohibition on proprietary trading, only softened by the strict exception contained in Article (6)(2)(i) will reduce the possibility to provide assets as collateral for the liquidity – providing operations of the Eurosystem.

[20] Cash equivalent assets must be highly liquid investments held in the base currency of the own capital, be readily convertible to a known amount of cash, be subject to an insignificant risk of a change in value, have maturity which does not exceed 397 days and provide a return no greater than the rate of return of a three-month high quality government bond.

[21] In particular, a core credit institution may only use interest rate derivatives, foreign exchange derivatives and credit derivatives eligible for central counterparty clearing to hedge its overall balance sheet risk. The core credit institution shall demonstrate to the competent supervisor that the hedging activity is designed to reduce, and demonstrably reduces or significantly mitigates, specific, identifiable risks of individual or aggregated positions of the core credit institution.

Moreover, there is an evident asymmetry between the instruments mentioned in Article 11 (1) of the proposal, which grants the exception to separation of trading activities for the purpose of prudent management of own risk, and the instruments indicated under Article 197 CRR as eligible as collateral under all approaches and methods, for credit risk mitigation[22]. Since the first list is much shorter, credit institution, which have been subject to a decision of separation, might encounter difficulties in getting assets eligible as collateral in order to mitigate their credit risk.

F Joint Discussion Paper of the Bank of England (BoE) and the European Central Bank (ECB) on "The case for a better functioning securitisation market in the European Union (EU)"

The EFMLG strongly supports the joint Bank of England (BoE) and European Central Bank (ECB) initiative on restoring the securitisation market. It is widely recognised that securitisations contribute in supporting the economy by providing companies, including small and medium-sized entities (SMEs), with alternatives in funding their business. Securitisations do, however, also create financial instruments (like asset-backed securities or ABS) that could be used as collateral for mitigating counterparty default risk. BoE and ECB have a well established practice in accepting certain qualifying ABS as collateral for its central bank credit operations. Other financial market participants, including prudentially regulated credit institutions and investment firms, use ABS as well. Article 197(1)(h) CRR explicitly recognises securitisation positions as eligible collateral under all approaches and methods, provided they have a certain minimum rating. Establishing principles for qualifying securitisations is a welcome first step towards a stronger securitisation market. It also broadens the pool of liquid collateral, which responds to the increasing demand for credit risk mitigation and which indirectly strengthens the financial system.

However, in order to meet the stated objectives, the eligibility criteria would need to be sufficiently broad, first of all in terms of underlying assets classes. The coverage should include auto loans and leases, other leasing receivables secured by aircrafts, marine container or equipments, consumer finance loans, credit card receivables, student loans, residential mortgages, commercial real estate receivables and leveraged loans, or software license receivables, to name just view of them. The requirement that the underlying assets must be subject to "consistent origination in the ordinary course of business" is understandable as it ensures the homogeneity of the portfolio. However, it would likely exempt multiple-originator securitisations, i.e., the securitization of assets that have been created by different lenders.

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[22] It has to be noted, tough, that Article 11 (3) empowers the Commission to adopt delegated acts to supplement the financial instruments mentioned in paragraph 1 by adding other financial instruments.

The qualifying securitisations should also include synthetic securitisations. We understand that traditional securitisation based on a true sale of the securitized assets to a special purpose vehicle (SPV) seems to be favourable as they put the underlying assets beyond the reach of the originator that securitizes the assets and its creditors. However, limiting the definition of “qualifying securitisations” to traditional securitizations, would remove a large number of transactions, which, at least from a prudential regulation perspective, are viewed as eligible (see Article 244 CRR). One example are securitisations of bank loan receivables, where applicable bank secrecy, data protection and privacy laws would prevent the bank from transferring the loans to an SPV. Another example are securitisations that use two-tiered structures involving two SPVs, where the first SPV holds the assets and where the second SPV issues the notes that fund the acquisition of the assets and where the funding is passed-on to the first SPV through a synthetic credit linked note. Most U.S. securitizations (including asset-backed commercial paper (ABCP) programs) are based on that two-tiered structure.

Another area to consider: The joint discussion paper does not indicate when the criteria for a qualifying securitisation should be fulfilled in order to classify a securitisation as ”qualifying”, i.e. whether they must be fulfilled upon acquisition only or on an ongoing basis. This is especially important for revolving securitisations, where exposures are added to or removed from the pool of exposures.

G - IOSCO Recommendations Regarding the Protection of Client Assets 29 January 2014

On 29 January 2014, the International Organization of Securities Commissions (IOSCO) established eight principles in their report regarding protection of client assets at regulated intermediaries. The issue has been in the spotlight especially following events such as the Lehman Brothers insolvency. At the core of the recommendations lie two regulatory challenges related to the protection of clients: (a) where a client has knowingly or unknowingly waived or modified the degree of protection applicable to client assets which it might be otherwise entitled and (b) the application of a domestic client asset protection regime where client assets are deposited in a foreign jurisdiction. In view of the above, documentary requirements are advised by the IOSCO Recommendations. In practice clear, affirmative and explicit declaration of consent is required to be provided by the client towards the intermediary[23].

Focusing on the third principle of the IOSCO Recommendations, it can be summarised in the following argument: An intermediary should maintain arrangements to safeguard the clients’ rights in client assets and minimise the risk of loss and misuse. Risk minimisation

[23] As opposed to deemed or implied consent, which is not sufficient in this case.

strategy consists of two elements: (a) sustainable prediction[24] of actions/decisions that can potentially generate volatility in respect to the status of the clients' assets and (b) pre-emptive evaluation of third party outsourcee during both the selection and pre-appointment phase as well as the post-appointment phase. Evaluation may include (i) legal requirements/market practices related to holding of client assets that could adversely affect clients' rights, (ii) financial condition, expertise and market reputation of the outsourcee, (iii) protection upon the regulatory status of the outsourcee and (iv) diversification and mitigation of risks.

Further to the above and within the scope of the current principle, an intermediary should be aware of the effect of liens and other encumbrances on client assets and take appropriate steps to ensure that any such lien or encumbrance is only granted to the extent permitted by the regulatory regime. Consequently an intermediary should consider the best interest of the clients when he agrees to liens or encumbrances.

In view of the above mentioned duties vested to the intermediary, it can be observed that the IOSCO recommendations introduce mainly an obligation of appropriate means, and not result. An issue subject to clarification is the potential minimisation of intermediaries' duties under the weight of clients' personal decisions. Should the answer to the above be an affirmative one, then the intermediary will be obliged merely to deploy the most appropriate network of sub-custodians working with similar standards, but will not be responsible for the clients' ultimate decisions. Consequently, when in practice a client is willing to invest in a specific asset class or in a specific country with a high risk, which would impose on the intermediary to select a counterparty that will practically be sub-standard by default, the duty of preemptive evaluation advised earlier will be subject to the availability of means.

In general the IOSCO principles facilitate regulator's supervision of intermediaries by focusing on their role in protecting clients' assets. While the intermediary is obliged to comply with client asset protection requirements, the regulator is responsible for supervision of both the intermediary's compliance with the domestic rules as well as maintaining a regime that safeguards clients' assets effectively.

[24] Either directly through in house analysis or indirectly by means of consultancy outsourcing

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