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Transaction Services Newsletter
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Clapham omnibus

There's trouble with the omnibus. Not another story about breakdown of the famous red London bus, but this time an account structure is in trouble – the well-known arrangement under which clients' securities are co-mingled in a single account held with their broker or custodian. In this issue we take a look at recent regulatory developments which affect the viability of omnibus accounts, starting with the FSA's new Client Assets Rules which take effect on 1 March 2011 (with some transitional relief until October).

The new CASS rule 6.3.5R will require a firm which holds clients' securities to ensure that any third party custodian with which the assets are deposited does not take a lien or right of sale over the assets, subject to certain exceptions. This looks like bad news for custodians who need to take security in relation to essential credit given when providing services such as settlement services. Fortunately, the exceptions do allow the firm to permit custodians to have a lien or right of sale for their charges and liabilities– but if and only if the lien or right *is confined to an individual client's safe custody assets* and extends only to the charges and liabilities arising from the provision of custody services *to that client*. (See CASS 6.3.6R for this exception to the no-liens rule.)

> "Even highly sophisticated clients who may be willing to bear the shared risks applying to an omnibus account are forced to have one of the other structures."

This new rule would appear to make it impossible for third-party custodians, wherever situated – that is, not just UK custodians – to take a lien or security for their charges incurred in relation to an omnibus account if the security comprises the totality of the assets in the account. Instead they must operate on an unsecured basis, or take separate security from the assets in the account, or divide up the account into a series of separate sub-accounts referable to individual underlying customers of the firm.

Single class travel

What is more, the new CASS rule does not distinguish between retail and other types of client (in Europe, non-retail clients may be classified as "professional clients" or "eligible counterparties") – so that even highly sophisticated clients who may be willing to bear the shared risks associated with charges applying to an omnibus account are forced to have one of the other structures, even if they are more expensive.

The rationale is presumably that a client should not be obliged to shoulder the risk that charges and liabilities properly referable to another client are secured on its own property. This seems reasonable enough. Indeed, in 1933, when in an English case Lord Justice Greer needed to point to an exemplary "reasonable man", he asked what the man on the Clapham omnibus would think. Yet, it seems a step too far if non-retail customers are not given the option of a more risky, but potentially cheaper alternative. An omnibus account may have efficiencies that a single-customer structure does not, such as net settlement and lower administration costs.

However, the FSA rules are now "made" rules and will be needed if there is to be any further change: firms and their custodians may have to reorganise their

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custody arrangements if securities held in omnibus accounts are subject to charges or liens.

We should also mention a few other aspects of the FSA's new rules:

- The no-liens rule (and the exceptions) applies equally to client money derived from client assets. Firms will have to give "no set-off" notices to custodians in so far as cash derived from client assets has to be classified as "client money".
- There are two other exceptions to the no-liens rule. If the customer's client money or assets are passed to a CCP or securities settlement system/depository which imposes a lien or right of sale or set-off under its operating terms, that is permitted for the purpose of settling the customer's trades. Finally, if the lien or right arises under foreign law or practice in relation to cash or assets outside the UK, it is also permitted if "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 that client".

Double decker

You wait ages for a bus and then suddenly five or six come along at once. Apart from the new CASS rules of the FSA, there are other bodies thinking about client assets and client money. We have noted quite a few initiatives:

- Various proposals, at European and (more advanced) at UK level, will provide mechanisms for immediate return of client assets and money to clients in an insolvency of an investment bank. These proposals may require re-shaping of how assets are held in order to provide operational underpinning for the new legal and regulatory rules. See *Market Developments* for more on these measures.
- Depositaries of alternative investment funds and UCITS will have enhanced liability for restoration of assets which become "lost".
- The modifications to the Investor Compensation Schemes Directive will require custodians to pay an up-front premium to their compensation scheme based on the value of assets under custody.
- The proposed Securities Law Directive will affect the legal rights which account-holders have, and in particular what rights an investor has to securities held in an omnibus account which is not in the investor's name.
- The Lehman collapse has called into question a number of practices associated with the handling of client money and client assets, and the UK courts have been busy on these issues.

None of these things directly attacks the omnibus structure. But omnibus accounts clearly do present a different risk profile to the client, and we would not be surprised if one or more of these initiatives about client assets and client money has important consequences for omnibus accounts. The only solution, it seems, is to keep a close eye on what is happening on the upper deck.

New FSA rules:
http://www.fsa.gov.uk/pubs/policy/ps10_16.pdf

Proposal to modify the Investor Compensation Schemes Directive:
http://ec.europa.eu/internal_market/securities/docs/isd/dir-97-9/proposal-modification_en.pdf

Responses to consultation for possible Securities Law Directive:
http://circa.europa.eu/Public/irc/markt/markt_consultations/library?l=/financial_services/harmonisation_securities&vm=detailed&sb=Title

UK cases on Lehmans client assets

Re Lehman Brother International (Europe) [2010] EWHC 2914

LBIE v RAB Market Cycles [2010] EWCA Civ 917

Market developments

Securities services

1. Centre of attention

Market infrastructure has never been so sexy. As well as the EMIR (the proposed European legislation on regulation of CCPs) there is now a plan for regulation of CSDs. Even if you are not a CSD, or not particularly convinced about their sexiness, this proposal is worth looking at, because – as is typical with legislative proposals – the back end of the proposal has a miscellany of proposals which are not about CSDs at all, such as settlement discipline and settlement timetables (T+2 for the whole of Europe?). The closing date was 1 March 2011.

Commission consultation on CSDs
http://ec.europa.eu/internal_market/consultations/docs/2011/csd/consultation_csd_en.pdf

2. You knew this was coming

What with all the debate on depositary liability in relation to the AIFM (hedge fund managers) Directive it was unavoidable that the European Commission would seek to re-align the obligations of UCITS (retail fund) depositaries, notwithstanding that the duties of depositaries was already subjected to a shake-up in July (to be transposed by member states no later than 30 June 2011). The Commission has carried out a consultation on this topic. The closing date was 31 January 2011.

Commission consultation on UCITS Depositaries
http://ec.europa.eu/internal_market/consultations/docs/2010/ucits/consultation_paper_en.pdf

Commission directive 2010/43/EU on (inter alia) UCITS depositary contracts
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:176:0042:0061:EN:PDF

3. Bust investment banks

The UK's legislation for resolving bust investment banks has come into force. This changes the law in relation to insolvency of "investment banks" (which includes deposit-takers and a wide range of other regulated firms who accept client assets or client money) to facilitate speedy return of client assets. The new regulations (unlike before) require administrators of a bust investment bank to deal with client asset claims, and allow them to impose a "bar date" for claims; they include a pro-rata distribution rule for shortfalls in omnibus accounts; they provide for administrators to "work with" market infrastructures to deal with things like unsettled market contracts; and (perhaps most importantly, for service providers) they impose an obligation on suppliers of data and other services, including CREST sponsorship services, to continue supply notwithstanding the insolvency proceedings. Sponsors and outsourcing service providers, look out.

UK Investment Bank Special Administration Regulations
http://www.legislation.gov.uk/uksi/2011/245/pdfs/uksi_20110245_en.pdf

4. Exchange mergers

You would not have forgiven us if we failed to mention this. What interests us is the implications for market infrastructures of the mergers, announced during recent weeks, of LSE and TMX, and NYSE and Deutsche Börse. LSE has a stake in CC&G and Monte Titoli. NYSE LIffe has been developing CCP functionality for its derivatives market. Deutsche Börse has a stake in Eurex Clearing as well as the ICSD and CSD operated under the Clearstream banner. Interesting times ahead, not just for the trading community.

5. Possession – the sequel

A.S. Byatt's literary love-story is more fun than this. You may remember our grumpy Summer 2010 edition about an English case (*Gray v G-T-P Group*), which had included stupendously uncommercial statements about the meaning of "possession" in connection with financial collateral. Things have moved on, and the plot has thickened. The UK Treasury has made amendments to the Financial Collateral Arrangements (No.2) Regulations 2003 which at last introduce a definition of "possession" into English law so it can no longer be said that it is impossible to "possess" dematerialised financial instruments. All good novel plots have twists and turns, and this is no exception. The definition says that you have possession if you have had securities credited to an account in your name (so far so good) but only provided that the collateral provider's rights are limited to substitution of collateral and withdrawal of excess collateral. The proviso is causing a good deal of anguish for collateral-takers who, before the Gray decision and the new regulations, thought they had good possession-based financial collateral arrangements.

Financial Markets and Insolvency (Settlement Finality and Financial Collateral Arrangements) (Amendment) Regulations 2010 (SI 2010/2993): http://www.legislation.gov.uk/uksi/2010/2993/contents/made

Clifford Chance briefing on Financial Collateral Arrangements:
http://www.cliffordchance.com/publicationviews/publications/2011/02/financial_collateralarrangementsand.html

6. Nothing certain but death and taxes

Allegedly something said by Benjamin Franklin. Or possibly the European Commission, who are consulting on cross-border withholding taxes in the context of dividend payments. At least with this one you get a decent period to respond – the deadline is 30 April – almost a lifetime compared with some of the other consultations.

Commission consultation paper
http://ec.europa.eu/taxation_customs/resources/documents/common/consultations/tax/withholding_taxes/wht_public_consutation_en.pdf

Market developments

Cash management and payments

1. Do cross-border ATM withdrawal fees make you cross?

The European Commission obviously doesn't like the idea that the ATM operator may deduct a fee from the ATM user/cardholder for making a withdrawal of cash. The legal problem is that Regulation 924/2009 requires that charges for cross-border payment services in euro be the same as for domestic payment services. The Commission Services has concluded that an ATM does not offer a separate payment service, so a machine offering euros cannot add a transaction charge to the amount debited from the cardholder's account resulting in a higher cost than a domestic withdrawal. Banks, ATM operators, and card schemes are going to have to work hard to comply with this ruling.

Commission Services opinion
http://ec.europa.eu/internal_market/payments/docs/reg-924_2009/application_direct_charging_en.pdf

2. More questions about foreigners

The European Commission has added yet more answers on the PSD to its FAQ page. The Commission has answered approximately 1000 questions, mostly concerning the PSD; and there are now FAQ on the Electronic Money Directive as well as other financial services legislation. One of the recent answers (to Q402) concerns non-EEA non-bank firms which wish to provide payment services within the European Union. Although non-EEA banks do not need to get a PSD licence to provide payment services in Europe, other types of non-EEA institution do need a licence, because they are not expressly carved out of the PSD.

Commission FAQ portal
http://ec.europa.eu/yqol/index.cfm

3. Bailing out

Since the financial crisis a good deal of attention is being paid to how the regulatory authorities ought to intervene in failing banks, and the parachute-preparation to be done by banks in case they need to bail out. The European Commission published a very significant paper on this question in January, which is (we are sure) on everyone's reading-list already. From the payments industry perspective there are a couple of things which merit particular attention. First, the Commission regards participation in wholesale payment systems as an indicator that the participant should be subject to its proposed crisis-management regime. Secondly, there is a proposal that there should be a short stay on exercise of rights such as close-out netting and suspension of payment and delivery obligations if the crisis-management regime needs to be applied. The stay may be dis-applied if the failing bank's counterparty is a payment or settlement system or a CCP, but that will be small comfort to larger banks which provide services to smaller banks enabling them to have indirect access to such systems.

Commission consultation paper
http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf

4. Another disaster

The UK's Payments Council has reported on its exercise, done last autumn, to test contingency arrangements for incidents which affect two or more payment systems.The Payments Council noted that the exercise:

- enabled potential opportunities to be identified to compress BACS timescales and enable delayed BACS payments to be processed more quickly once BACS was restored;
- encouraged participants to consider re-routing;
- found that communications could have been more 'joined up' in terms of their content and timing; and
- highlighted the need for the industry to give further thought to the scope and extent of any indemnity offered to customers that their interest would be protected.

UKPC report
http://www.paymentscouncil.org.uk/files/payments_council/new_website/pce10_review.pdf