



MiFID: client money

This briefing considers the FSA's proposals for implementing MiFID's client money requirements. Notwithstanding the loss of the professionals opt-out, it explains that the key transition action for many firms will be repapering and not segregation.

The Financial Services Authority (FSA) invited comments on CP 06/14 by the end of October. Published this summer, the CP examines the implementation of the Markets in Financial Instruments Directive (MiFID) for firms and markets. The FSA's discussions with industry have continued to date, and its proposals for client money are generally considered to be helpful. The key transition action for many firms will be repapering, as opposed to segregation.

This briefing looks at the FSA's proposals.

Client money in MiFID

MiFID imposes a general duty to segregate client money at level 1 in article 13(8). Recital 26 indicates that the segregation requirement should not prevent agency arrangements such as securities lending to which the client consents, and recital 27 provides broadly that financial collateral provided under title transfer arrangements in line with the Financial Collateral Directive (FCD) or other EU legislation should not be regarded as belonging to the client. The level 2 Directive very broadly requires firms promptly to place client funds with a central bank, EU authorised bank, third country authorised bank or qualifying money market fund, and to use skill, care and diligence in selecting any such bank or fund (other than a central bank). Certain operational protections are also specified and compliance with the requirements must be audited.

Loss of professionals opt-out and prime brokers

There is no equivalent in the MiFID regime to the pre-MiFID UK professionals opt-out. This raised concerns in the London market, especially among prime brokers. These may be non-bank entities, who do not customarily segregate 'free cash' (cash not needed to support margin requirements) received from hedge funds pending investment. Aware of such concerns, the FSA has sought functionally to replicate the effect of the professionals opt-out as follows.

Title transfer collateral arrangements

Draft CASS 7.2.3 picks up and develops recital 27 by taking out of the client money regime (broadly) money the full ownership of which is transferred to the firm to secure or cover present or future, actual or contingent or prospective obligations. This clearly protects prime brokers taking hedge fund assets under title transfer arrangements. However, it is customary for prime brokers to take security over cash balances as well. It was, therefore, necessary to show that the client money regime does not apply to such arrangements.

Transfer of full ownership through payments system

The answer here is to look at the legal nature of a cash payment. The transfer of cash by the hedge fund to the prime broker as collateral, in effect, involves the transfer of title to that cash. The debt of the prime broker to the hedge fund in respect of the cash balance is then charged back to the hedge fund. The FSA has accepted this

analysis. This acceptance is consistent with the language of CASS 7.2.5, which in effect provides that money brought out of the client money regime by 7.2.3 is not brought within it again by charge back arrangements.

Repaper, not segregate

In CP 06/14, the FSA notes the loss of the professionals opt-out but refers to recital 27 and comments, 'We think that these Recitals would allow many existing arrangements to continue.' In the cost benefit analysis of the draft client asset rules implementing MiFID, the FSA gave a broad indication that the transition to the MiFID regime should not generally involve the extension of client money to currently opted-out professional clients, but only repapering.

Non-professional clients

Neither recital 27 nor CASS 7.2.3 distinguishes between different categories of clients. However, the FSA seeks to address the danger of non-professional clients being unfairly deprived of client money protections in both CASS 7.2.6, which reminds firms in this connection of their obligations to act honestly, fairly and professionally in accordance with the best interests of their clients, and CASS 7.2.7. This imposes certain restrictions on the use of 7.2.3 for retail clients, including a requirement that there be '... a reasonable link between the timing and amount of the collateral transfer and the obligation that the client owes, or is likely to owe, to the firm'.

MiFID opt-in

Chapter 4 of CASS contains client money rules for non-MiFID designated investment business; chapter 5 provides such rules for insurance mediation activity; and chapter 7 contains MiFID client money rules. CASS 7.1.3 enables firms to opt such non-MiFID business into the MiFID regime (the FSA is assessing the interaction between the client money requirements in the Insurance Mediation Directive and MiFID to infer whether it will be possible for firms to opt client money related to insurance mediation activities into CASS 7). It is considered likely that many firms will opt all their client money business into the MiFID regime to avoid the operational burden of running more than one compliance platform. (Successfully operating one client money platform is generally regarded as a sufficient challenge.)

Qualifying money market funds

There is provision under MiFID and the draft client money rules enabling firms to place client money in qualifying money market funds. (It is already common for custodians to offer such a 'cash sweep' into 'near cash' money market funds since the Barings crisis of 1995 to address custodian credit risk.) The use of money market funds under this provision of the client money regime is subject to the clients' right of veto, and curiously the right of veto seems to enable the client to specify 'all or nothing' ie to object to the asset class but not to a particular fund.

The definition of qualifying money market fund for this purpose is narrow, in that all underlying assets of the fund must be given the highest rating by all qualifying rating agencies ie rating agencies that are eligible External Credit Assessment Institutions (ECAIs). There are some 60 such qualifying rating agencies, and monitoring them all would be a considerable burden. A better route for firms might be simply to (continue to) agree contractual cash sweep arrangements with their clients without relying on this power and without the obligation to comply with the related restrictions.

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