

Clients & Friends Memo

Changes to the Rules on Client Assets: Implications For Prime Brokers and Funds

25 February 2011

Background and Timing

On 1 March 2011, a series of amendments to the FSA's Client Assets Sourcebook ("**CASS**") come into force that will require the repapering of relationships between prime brokers and their fund customers as well as a review of any liens granted in custody agreements.

These amendments are set out in FSA Policy Statement 10/16¹ which also contains new rules to: (i) limit deposits of client monies with other group entities to a maximum of 20% (comes into force on 1 June 2011); (ii) require firms to make a Client Money and Asset Return ("**CMAR**") (comes into force on 1 June 2011²); and (iii) establish a CASS oversight controlled function (comes into force on 1 October 2011).

Scope

The new CASS provisions apply to UK authorised prime brokers and their overseas branches, and the UK branches of non-European prime brokers. The new rules do not apply to UK branches of incoming European prime brokers.

A prime brokerage agreement ("**PBA**") is defined as an agreement for "prime brokerage services", which are in turn defined as a package of services that must include the right of the prime broker to use safe custody assets for its own account, the provision of custody services, the provision of clearing services and financing (one or more of capital introduction, margin financing, stock lending, stock borrowing, repo and reverse repo arrangements). This will

¹ See http://www.fsa.gov.uk/pubs/policy/ps10_16.pdf.

² Although note that on 10 February 2011 the FSA published a consultation paper on the operational implementation of the CMAR which contains a proposal for a phased approach to implementing the CMAR. See http://www.fsa.gov.uk/pubs/cp/cp11_04.pdf.

capture large and small prime brokers, but should exclude from the rules' scope agreements with other service providers such as wealth managers, custodians and depositories.

Prime Brokerage Agreements: New Rules In Force 1 March 2011

1. *Requirement For a Disclosure Annex:* As of 1 March, PBAs must include an annex summarising the key provisions within the PBA permitting the use of safe custody assets. The new Rule, CASS 9.3, sets out the content of the annex, which must include:

- any contractual limit on the amount of safe custody assets that the prime broker may use;
- all contractual definitions that go towards making up the elements of that limit;
- cross-references to provisions in the PBA that allow the use of safe custody assets; and
- a statement of the key risks if a client's safe custody assets are used, including risks on the failure of the prime broker.

2. *Requirement to Make a Daily Report to Clients:* As of 1 March, prime brokers must make available to each of its clients to whom it provides prime brokerage services a daily report of close of business values of the following no later than the close of the next business day:

- custody assets and client money held for the client;
- cash loans and accrued interest;
- securities to be redelivered by the client under open short positions;
- futures' settlement amounts to be paid by the client;
- short sale cash proceeds belonging to the client;
- cash margin in respect of open futures contracts;
- mark-to-market close-out exposure for any OTC transaction secured by a safe custody asset or client money;
- the client's total secured obligations to the prime broker;
- all other safe custody assets held for the client;
- total collateral held by the firm including where the firm has exercised its right to use safe custody assets;
- the location of safe custody assets; and
- a list of all institutions where the prime broker holds or may hold client money.

3. *Limits on Liens in Custody Agreements:* As of 1 March,³ agreements with third party custodians may only include a lien, right of retention or sale or right of set-off over safe custody assets or any client money derived from such assets to the extent that the provision relates to: (i) charges and liabilities properly incurred as a result of the provision of custody services; (ii) liens or rights created in favour of securities depositories, securities settlement systems or

³ Note, however, that there are transitional provisions relating to agreements executed before 1 March 2011 which provide that the new rules on custody agreements do not apply to such agreements until 1 October 2011.

central counterparties (provided that the lien or right in question only arises for the purpose of settling that client's trades); or (iii) liens or rights which arise in jurisdictions outside the UK as a result of local regulatory requirements or market practice (and the prime broker has first determined that holding assets in that jurisdiction is in the best interests of the client).

What is Next?

The FSA has declined to extend the commencement date for the disclosure annex and daily reporting requirements and the clear expectation of the FSA is for prompt repapering of relationships. The Alternative Investment Fund Managers Directive also speaks to prime brokerage agreements, but given that has yet to be implemented, it is too early to say whether that Directive will cause revisions to these FSA rules.

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