Briefing note
August 2011

FSA prohibition on custody liens over client assets

On 1 March 2011 the UK Financial Services Authority (FSA) published a new rule in its Client Assets Sourcebook (CASS 6.3.5R), which requires a UK firm that holds securities on behalf of its underlying clients (a "**Firm**") to ensure that any third party custodian with which the assets are deposited does not take a lien or right of sale over those assets, subject to certain exceptions. The rule applies irrespective of the location of the custodian.

Key issues:

- General prohibition on granting liens over client assets in favour of third party custodians
- FSA consulting on plans to broaden scope of exceptions
- Some uncertainty over interim relief

The prohibition came into effect immediately on 1 March 2011 but the FSA has granted provisional relief, expiring on 1 October, in respect of custody agreements entered into before 1 March. However, custodians and their clients expressed concerns that the proposed exceptions to the prohibition were too narrow and would effectively prevent custodians from taking liens over all assets in an omnibus account (which is common practice). The FSA has therefore proposed to "switch off" the new rule from 1 October 2011 until 31 March 2012 (inclusive) to allow time to modify the wording of the exceptions to address these concerns. The FSA published a consultation paper on its proposed modifications on 29 July. The deadline for responses regarding the modifications is 28 October and the deadline for responses on measures for interim relief is 29 August.

When does the rule apply?

The new rule applies to three-party situations, where there is a client, a Firm, and a third party custodian with whom the Firm has deposited the underlying client's assets. If a custodian accepts assets from a client, i.e. where only two parties are involved, the rule does not prohibit the custodian from taking a lien or security interest (though if the custodian is itself a regulated Firm it may have to apply the rule to its sub-custody arrangements).

Even in a three-party case, the restriction does not apply if the Firm grants a security interest in favour of the custodian over the Firm's own *proprietary* holdings of assets. This will be the case where, for example, the Firm has agreed "rights of use" or "rehypothecation" with its underlying client and has acquired ownership of that client's assets.

Where the security interest is over assets owned by the Firm's underlying clients, the restriction will apply. However, there are exceptions under CASS 6.3.6R, as follows:

a) where the security relates to charges and liabilities of the custodian, or of a sub-custodian, arising from custody services provided for the benefit of a particular underlying client of the Firm; or

b) where the assets of an underlying client are located outside the UK and the granting of such security is (i) a local legal requirement or a necessary precondition for participation in a local market and (ii) reasonably determined by the Firm to be in the best interests of that underlying client.

There is also an exception regarding omnibus accounts held at securities depositories, in securities settlement systems and at central counterparties.

As currently formulated, the rule creates difficulty for Firms that hold their securities in an omnibus account with a custodian that needs to take a charge or lien over the account. The new FSA proposal is designed to overcome that difficulty.

Issues arising from the current drafting of the rule are discussed in greater detail in the March 2011 edition of Clifford Chance's Transaction Services Newsletter.

The proposed changes

(a) Properly incurred charges and liabilities

The FSA has proposed to modify the exception for liens over omnibus accounts covering properly incurred charges and liabilities arising from the provision of custody services. They have suggested that the exception should apply to "safe custody assets held in that account" rather than the assets of the specific underlying client to whom those charges and liabilities relate. This reflects the concern that although identifiable in the Firm's books and records, it is not easy or in some cases possible for the custodian to identify which specific assets belong to each individual underlying client of the Firm.

A similar change is suggested in respect of the exception regarding omnibus accounts held at securities depositories, in securities settlement systems and at central counterparties.

(b) Overseas jurisdictions

The FSA has also made two changes to the exception for liens required to access markets in jurisdictions outside the UK. Under the current provisions the lien must either be required by local law or must be "a necessary precondition for participation in a local market" and, in either case, the Firm must have taken "reasonable steps" to determine that holding the assets (or money derived from them) subject to such a lien is in the best interests of the Firm's clients.

Market participants have expressed concerns that "necessary precondition" may be too strict a requirement as Firms have had different degrees of success in negotiating to remove liens from agreements with custodians in overseas jurisdictions. Where just one Firm is able to remove a lien (due to market strength or otherwise), it casts doubt on whether other Firms are in compliance with this requirement. The FSA has therefore proposed to amend the provision such that the lien must be "necessary for that Firm to gain access to a local market".

Another concern expressed with the exception is that taking "reasonable steps" to determine whether the lien is in the best interests of the Firm's client is inappropriate in the case of a professional client that has instructed the Firm to hold assets in the relevant jurisdiction notwithstanding the existence of the lien. The FSA has proposed a carve out to the provision for these situations.

Interim relief

As noted above, the FSA has proposed to "switch off" the new rule from 1 October 2011 until 31 March 2012 (inclusive) to allow time to modify the wording of the exceptions. However the FSA has not made any clear statement regarding the status of the rule on agreements entered into between 1 March and 30 September. It seems logical to assume that the FSA would not penalise Firms that enter into custody agreements that fall within the exceptions as it proposes to modify them, for example agreements that permit a lien over an omnibus account covering properly incurred charges and liabilities arising from the provision of custody services.

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