THE INSTITUTE OF CHARTERED ACCOUNTANTS
IN ENGLAND AND WALES

4 July 2008

Our ref: ICAEW Rep 79/08

Your ref:

Financial Services Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

By email cp08_06@fsa.gov.uk

Dear Sirs

CONSULTATION PAPER 08/6 – Review of the Client Assets sourcebook (CASS)

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the Consultation Paper "Review of the Client Assets sourcebook (CASS)".

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 79/08

FSA – Review of the Client Assets sourcebook (CASS)

Memorandum of comment submitted in June 2008 by The Institute of Chartered Accountants in England and Wales in response to the FSA Consultation Paper 08/6.

Contents	**Paragraph**

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the FSA's Consultation Paper 08/6 –Review of the Client Assets sourcebook (CASS) issued by the Financial Services Authority in March 2008.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

4. Our responses to the questions raised in the Consultation Paper are set out below.

5. We would support the approach being taking by the CP in moving to a more principles-based approach to the rules around client money and custody assets. In general we are supportive of the proposals in the CP and can see benefits for both regulated firms and consumers. There are, however, a number of areas where we consider the proposals could benefit from some refining and these are set out in the Appendix. We have a couple of major points which we would like to raise for consideration by FSA.

6. First, we are proposing a review of the format and requirements of the auditors' client assets report to FSA. The format of the report goes back to the client assets rules of previous regulators, rules which have been subject to a number of changes. The current European requirements are set out in the MiFID directives. We are proposing that consideration be given to removing the requirement for reporting on compliance with the client asset rules at a point in time and removing the need for a report where a firm is not authorised to hold client assets. These matters are discussed in detail in the answer to question 29.

7. Second, we are suggesting that a maximum time be set between certain reconciliations of client money and custody assets rather than an open ended 'as appropriate' requirements. Further detail is set out in the answers to Questions 10 and 21.

ANSWERS TO DETAILED QUESTIONS

Chapter 4 – Merging the custody rules

Q1: ***Do you agree with the relevant proposals? If not, why not?***

8. We would agree with keeping the exemptions for operators of regulated collective investment schemes 'in relation to activities carried on for the purpose of, or in connection with, the operation of the scheme' and temporary safekeeping for personal investment firms.

Q2: ***Do you agree with the concept of retaining the concessionary regimes? If not, why not?***

9. We see no reason for removing the concessionary regimes. They appear to have worked as required.

Q3: ***Do you agree with the manner with which we have updated the concessionary regimes? If not, why not?***

10. The amendments to the concessionary regimes seem reasonable. Our main concern is that the operation of the regimes and these changes may not have been explained well enough for those operating under them to appreciate the implications of the changes.

Q4: ***Do you agree with our proposal? If not, why not?***

11. We would see no reason not to apply the requirements in CASS 6.2.1 R and CASS 6.2.2 R to all firms.We would have expected firms to have made "adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the firm's insolvency, and to prevent the use of safe custody assets belonging to a client on the firm's own account, except with the client's express consent."

Q5: ***Do you agree with this proposal? If not, why not?***

12. We would expect a firm to have a duty under CASS 6.2.1 and CASS 6.2.2 to consider the appropriateness of a client's request to have entitlement recorded in the name of another person and make enquiries where the firm has concerns. On this basis we do not believe it is necessary to carry across to CASS 6 the requirements referred to in CASS 2.2.10(5) and CASS 2.3.11.

Q6: ***Do you agree with our proposals? If not, why not?***

13. This is an area where there is scope for firms to read CASS and conclude that no specific requirements exist. We understand the desire to simplify by not repeating COBS requirements in CASS. But we believe that some form of cross reference to

the requirements in COBS should be included within CASS. We take this opportunity to draw to FSA's attention the fact that these rules are no longer in CASS means that they are outside the scope of the work carried out by the auditor to report under SUP 3.10.

Q7: ***Do you agree with our proposals? If not, why not?***

14. We would support the view that applying the requirements in CASS 6.3 to all firms is an appropriate approach in requiring the firm to exercise "due skill, care and diligence in the selection, appointment and periodic review of the third party".

Q8: ***Do you agree with our proposal? If not, why not?***

15. Most circumstances where a firm uses a safe custody investment for its own account, or for the account of another customer are likely to fall under the MiFID requirements or be in respect of a retail client and hence the proposal would not lead to a change. On this basis and as a matter of simplification we would support the proposal.

Q9: ***Do you agree with our proposal? If not, why not?***

16. While we have no indications of major concerns in respect of this proposal we note that the firms themselves will be in a better to position to confirm that this is actually the case. We note, however, that there will be a need for certain firms to review their arrangements for stock lending if this proposal is implemented.

Q10: ***Do you agree with our proposal? If not, why not?***

17. We recognise the proposal as part of the FSA's process of moving to principles-based regulation. At first sight it seems reasonable to allow firms more flexibility where they can demonstrate that they are performing reconciliation as often as is reasonably required in all the circumstances is. However, we have concerns from an auditor's point of view as to the level of judgement and possibility of divergent views on what may be considered 'adequate to enable compliance with the rules' (CASS 6.5.14). In particular we see the possibility of disagreement between the firm and its auditor over the necessary frequency of reconciliations. A firm may argue that a six monthly or once a year reconciliation is adequate on the basis that in the past no errors have been identified. Most auditors would argue for more frequent reconciliations if only to confirm that there are no errors. We recommend that the FSA consider whether a maximum period between reconciliations should be set, (for example six monthly) albeit this may be 'super equivalent' for MiFID purposes.

Q11: ***Do you agree with our proposal? If not, why not?***

18. We do not see any difficulties with changes the requirement to keep records from 3 years to 5 years.

Q12: ***Do you agree with our proposals? If not, why not?***

19. We have no comment.

Q13: ***Do you agree with our proposals? If not, why not?***

20. We agree with this proposal and see no reason why the custody rules should not apply to the assets of affiliated companies.

Chapter 6 Merging the client money rules

Q14: ***Do you agree with our proposal? If not, why not?***

21. We have no evidence that there have been any significant problems arising from the exemption from the client money rules for solicitors carrying on non-MiFID business. Unless other respondents have information to the contrary we would support the retention of the exemption from client money rules for solicitors.

Q15: ***Do you agree with the retention of a concessionary regime for trustee firms?***

22. We have no comment.

Q16: ***Do you agree with the manner in which we have updated the specialist regime?***

23. We have no comment.

Q17: ***Do you agree with our proposal? If not, why not?***

24. We would support the retention of the 'professional opt-out provisions for non-scope firms'. We assume this opt-out would also be available in respect of non-MiFID business carried on by MiFID firms but note that the proposals do not make this clear.

Q18: ***Does your firm make use of the opt-out? If so, could you please explain why you think it should be retained?***

25. In some cases it may not be possible for a regulated firm to carry on business without holding money belonging to clients, in certain of these circumstances the 'professional opt-out provisions for non-scope firms' provides a means of delivering a service to a client at a reasonable cost without incurring the complications of adopting client money requirements in detail.

Q19: ***Do you foresee any difficulty in removing the opt-out provisions in CASS 4, and making available to all firms the full title transfer collateral arrangements contained in CASS 7?***

26. If the 'professional opt-out provisions for non-scope firms' is to be removed we would generally support some form of grandfathering for existing clients and the application of the title transfer collateral arrangement requirements only to new clients. However, firms should be given the opportunity to elect to move all clients to title transfer collateral if they so wish. We note that if non-MiFID firms need to adopt the title transfer collateral arrangements then not only would this be potentially more complicated, but would also require additional time and effort in 'repapering' agreements. We are not convinced that there would be any benefits from requiring this process.

Q20: ***Do you agree with our proposal? If not, why not?***

27. If firms are already retaining records for a greater period then the change should present no problems.

Q21: ***Do you consider there will be any difficulties in applying the MiFID standard to all firms?***

28. The MiFID approach requiring "firms to conduct 'regular' external reconciliations" rather then setting specific timescales is a reasonable extension of the application of principles to financial regulation. It allows flexibility to reflect the level of client money held and the circumstances in which it is held.However, as with custody assets (see question 10) we have concerns from an auditor's point of view as to the level of judgement and possibility of divergent views on what may be considered 'regular'. In particular we see the possibility of disagreement between the firm and its auditor over the necessary frequency of such reconciliations. We recommend that the FSA consider whether a maximum period between such client money reconciliations should be set, (for example monthly) albeit this may be 'super equivalent' for MiFID purposes.

Q22: ***Do you agree with our proposal? If not, why not?***

29. As long as the same procedures and processes are followed as for money kept at a third party bank we can see no major concern over the removal of the notification requirements when money is to be kept with a group bank. In the interests of treating customers fairly we recommend that there be some form of disclosure in circumstances where the regulated firm's relationship with the group bank is not on normal commercial terms.

Q23: ***Do you agree with our proposal? If not, why not?***

30. We accept that the firm has to do appropriate initial and periodic review of the banks it selects to hold client money and that this puts the onus on the firm to evidence the 'standing' of the banks it uses. We are concerned, however, by the fact that they may use any 'bank authorised in a third country'.The use of a central bank, a BCD credit institution or a qualifying money market fund does not seem unreasonable

Q24: ***Do you agree with our proposals? If not, why not?***

31. This proposal appears to be missing the point. A designated account under CASS 4 is not just an individually named account (or fund account). Although not used to any great extent the 'designated' account requirements were designed to segregate those accounts in the event of a bank failure or other 'pooling' event. Designated accounts are separately pooled in such circumstances. The distribution rules are discussed briefly in section 8 of the CP.

Q25: ***Do you agree with our proposals? If not, why not?***

32. We agree that the main circumstances where such requirements are of benefit is in respect of Delivery Versus Payment (DVP) transactions covered in CASS 7.2.8 R but there may be others which, if CASS 7.2.2 was removed may require firms to apply for a waiver. We do not believe that the case for applying 'super equivalence to the MiFID requirements by the removal of CASS 7.2.2 has been made.

Q26: ***Do you use CASS 7.2.2 R to exempt any transactions other than DVP transactions?***

33. We have no comment.

Q27: Do you agree with our proposal? If not, why not?

34. We are not aware of any specific examples of difficulties this change will create. The difference between an approved bank under the CASS 4 rules and a credit institution under CASS 7 is a subtle one. As stated in the CP many non-EEA entities will in practice establish a subsidiary in the UK and on this basis, geographic issues will fall away.

Q28: ***Do you agree with our proposals? If not, why not?***

35. We would support this proposal. It provides consistency of approach with the treatment of custody assets (see Question 13) and we see no reason why a firm that holds money on behalf of, or receives money from, an affiliated company should not treat the affiliated company as any other client of the firm for the purposes of the client money rules.

Chapter 7 SUP 3 – 10 Audit requirements

Q29: ***Do you agree with our proposals? If not, why not?***

36. We do not support the removal of the guidance in CASS 7.6.17 to CASS 7.6.19 as we believe it is necessary for there to be a cross- reference to the audit requirements, particularly those referred to in CASS 7.6.17 which are not contained elsewhere within CASS.

37. We would also take this opportunity to ask the FSA to consider the need for certain aspect of the current requirements set out in SUP 3.10, particularly in relation to the wording of the client assets auditor's report.

38. Unlike prudential aspects of FSA regulation, where the requirement for an auditor's report has been removed for investment firms, there is still a requirement for an auditor's report on client assets. We believe that following the introduction of MiFID and with the move to more principles-based regulation it is an appropriate time to reconsider the requirements in respect of auditor's client assets reports. Indeed, we note that the current wording and structure of the auditor's client's assets report to the FSA goes back to the client assets rules of previous regulators and much has changed since then.

39. It is recognised that the FSA is limited in its ability to remove the requirement for an auditor's report on client assets by European Directives, particularly Article 20 of 2006/73/EC. This directive requires an annual report from the regulated firm's external auditors on:

    (i) arrangements to safeguard clients' ownership rights of custody assets, especially in the event of the investment firm's insolvency and to prevent the use of a client's instruments on own account except with the client's express consent;
    (ii) arrangements to safeguard the clients' rights to client money and, except in the case of credit institutions, prevent the use of client funds for its own account.

40. There are two areas of current reporting which do not appear to be required by these directive regulations and the need for these could benefit from further consideration. First the requirement to report on compliance with the rules at a point in time, usually the year or period end under the current arrangements. Second, the need to provide negative assurance to FSA where firms are not authorised to hold client money and/or custody assets.

41. This latter point seems at variance with the rules in respect of regulated firms carrying on insurance mediation activity. The FSA may be of the view that they would want to know that a firm which is not authorised to hold client money and/or custody assets is not actually doing so. However, some assurance could be obtained in this area from the fact that any auditor who identified that a firm which was not authorised to hold client money and/or custody assets was doing so, would have to consider whether there was a duty to report under the 'FSMA 2000 (Communication by Auditors) Regulations 2001 and ISA 250 Section B.

42. In the event that the wording of the SUP 3.10 report is changed, we would suggest that the FSA consult with the Auditing Practices Board (APB) on changes to the wording of the auditor's report before its rules are finalised.

43. We draw attention to the fact that PN21 was published by the APB, not the ICAEW as stated in paragraph 7.1 of the Consultation Paper.

Chapter 10 Client money – insurance mediation activity

44. The CP appears to have two question 32s, these have been marked as 32(A) and 32(B) below.

Q30: ***Do you agree with these statements, or have any comments to make on this matter?***

45. We believe that the current rules are adequate. If certain types of funding from Statutory Trust Accounts were permitted, this is likely to lead to confusion and potentially increased credit risks. If funding is historically high, firms could operate non-statutory trust accounts. Otherwise firms should consider performing the client money calculation more frequently (CASS 5.5.63R requires that calculations are performed as often as necessary and at least at intervals of not more than 25 business days). Surpluses of commission withdrawn into general office accounts could then be used for small, one-off funding requirements such as return premiums.

Q31: ***Do you agree with these statements, or have any comments to make about this?***

46. In most cases, firms already use balances from business ledgers to perform the client money calculation and often perform the bank reconciliation on the same day. This ensures that cash balances used within the calculation are complete and accurate. We would, therefore, agree with the statement that if a firm is using fully reconciled cash figures within its client money calculation, it should not have to perform a further bank reconciliation within ten days of the calculation.

Q32 (A): ***Are there any other terms for which plain English guidance and examples would be useful?***

47. We agree with the statement that clarity is required around 'informed consent.' Specifically, we believe that guidance is required around how informed consent differs from other types of consent (for example, explicit consent) and at what point the FSA considers these various consents as being achieved by firms.

Q32 (B): ***Do you have views on that possibility or have any other comments to make in this context?***

48. We agree that further guidance in relation to the policies firms should have in respect of credit write-backs would be helpful. As the 6 year rule in CASS 4.3.105(1)(b) indicates, this is a longer-term issue that cannot easily be resolved by quick immediate solutions. We would also raise the issue of unallocated cash and legacy, from which credit write-backs usually arise and whether the FSA has considered any guidance in relation to these issues.

Q33: ***Do you have views on that possibility or have any other comments to make in this context?***

49. The results of the thematic review on client money is consistent with our own experiences in that the periodic segregation approach as set out in CASS 5.5.23R appears to be rarely favoured by firms. This seems to be due to the practical difficulties in having to monitor, estimate and then hold equal amounts of client money as held by their Appointed Representatives. We would, therefore, support greater flexibility with

the rules for firms who may wish to adopt the periodic segregation approach but recognise the need to maintain adequate protection for clients' funds.

Q34: ***Do you agree with these statements, or have any comments to make in this regard? It would be helpful if industry respondents would please indicate whether their firms follow the British Insurance Brokers' Association Code of Practice which addresses this issue.***

50. We understand that the insurance intermediary market has made significant use of risk transfer arrangement for client money. This may have been partly driven by market conditions and the desire by insurers to secure distribution and, therefore, perhaps being more open to agreeing to arrangements such as risk transfer in order to obtain or retain business.

Q35: ***Do you have views on that possibility or have any other comments to make in this context*****?**

51. It would assist in firms' awareness of the audit requirements in respect of client money arising on insurance mediation if the requirements were all within CASS or at least a cross- reference was contained within CASS. If such amendments were made appropriately it would assist in clarifying the two audit requirements i.e. the annual client money audit in accordance with SUP 3 and the non-statutory systems and controls audit verification in accordance with CASS 5.4.4R.

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