## Markets in Financial Instruments Directive II Implementation

ICAEW welcomes the opportunity to comment on CP 16/19 *Markets in Financial Instruments Directive II Implementation* published by Financial Conduct Authority on 29 July 2016, a copy of which is available from this link.

This response of 28 October 2016 has been prepared on behalf of ICAEW by the Financial Services Faculty. As a leading centre for thought leadership on financial services, the Faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector. The Faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

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## MAJOR POINTS

### General comments

1. We welcome the opportunity to comment on the Consultation Paper (CP) 16/19, Markets in Financial Instruments Directive II Implementation – Consultation Paper II. Although we feel that the changes introduced could potentially have a significant impact we only seek to respond on a limited number of questions namely the ones related to the Client Asset Sourcebook (CASS) as we consider these chapters the most relevant to the work we have been conducting within ICAEW. In addition to responses to specific questions please see below a few observations in general relating to the changes proposed which would have a significant impact on CASS regulated firms.

## RESPONSES TO SPECIFIC QUESTIONS

### Q17: Do you agree with our proposal to implement MiFID II requirements for MiFID and non-MiFID business maintaining a single rulebook? If not, please give reasons.

2. Yes we do. Maintaining a single rulebook will enable CASS regulated firms to adhere to CASS rules with less difficulty and will ensure that MiFID firms performing non-MiFID business can rely on one rulebook and should help firms accurately categorise their activities (which, in our experience, can be an issue for smaller firms). Additionally, from an audit perspective, the single rulebook approach helps to ensure auditors are familiar with the rules and keeps their internal training and procedure costs at a manageable level (costs that would otherwise be passed on to firms).

### Q18: Do you agree with our proposals to implement MiFID II safeguarding of client assets provisions? If not, please give reasons.

3. Overall we agree with the proposed changes. However we have some observations we would like to share with the FCA and these are set out below.

4. The restriction for not using TTCAs for retail client business has been anticipated for some time. We note that ESMA has previously commented on securities lending arrangements for retail clients (as already permitted under CASS 6.4.1A G) and that alternative mechanisms are likely to be available for firms; we consider that some guidance in this area to assist any impacted firms would be a welcome addition to CASS 6.4 and/or CASS 6.1 (in the TTCA section).

5. The proposals and, in particular, the CBA do not appear to take account of the widespread use of TTCAs in relation to certain transactions. For example, any firm using an ISDA supported by a credit support annex that provides for title transfer will be caught by these proposals and will therefore need to perform due diligence on whether the (prospective) client can afford to do business with the firm. We are not aware of this being a widespread practice in the wider derivatives industry (as opposed to, for example, prime broking).

6. With regard to securities lending and the new rule proposed at CASS 6.4.2A R (and the associated guidance at CASS 6.4.2B G), we are concerned that this may bring nearly all securities lending activities within the scope of CASS 6. If this is the intention, then we do not consider that this has been reflected within the CBA. On the other hand, if the intention is that the status quo – where most lending takes place for professional clients and collateral is held under a TTCA (usually provided for within an industry-standard GMSLA contract) in order to secure the client's obligation to repay the borrower – then we consider that this can be made clearer through additional guidance within CASS 6.4 (for example, through expanding CASS 6.4.2B G) would be a welcome clarification.

7. Following MiFID II, the update of CASS 6 proposes to introduce further restrictions on liens. General liens have been banned with limited exceptions but MiFID II further narrows the exceptions to applicable law in a third-country jurisdiction in which the client's assets are held. We understand that such liens can significantly delay or obstruct recovery of assets however we feel that due to these restrictions firms with global custody networks with allowable liens under the current rules would have to renegotiate agreements which may not be achievable before the new rules apply. This would restrict the ability of investors to hold assets in certain jurisdictions. We also note that if firms are expected to obtain appropriate local legal advice in respect of each jurisdiction that assets are (or may be) held, then this will incur significant costs for firms with an international portfolio (and this has not been reflected within the CBA).

8. The extension of the requirements regarding sub-custodians means that regulated firms must have a detailed understanding of the sub-custodian network arrangements. While this could be considered an implicit condition of custodian/sub-custodian arrangements while performing due diligence work, we recommend that the FCA clarifies whether this requires regulated firms to have a strong oversight over their sub-custodian network, i.e. how far down the custody chain does a firm need to go? We acknowledge that the text within the MiFID II delegation does not make this particularly clear (e.g. the wording at Article 3 paragraph 4 does not make clear *to whom* paragraphs 2 and 3 must apply to), however we consider that this can be addressed through clearer guidance within CASS 6.3. Some firms may also read this across to CASS 6.6 and consider that external reconciliations must be similarly extended to other third parties within the chain of custody (and would therefore welcome clarification through guidance connected to CASS 6.6.34R and 6.6.35R, for example through the addition of an extra sentence to CASS 6.6.36G).

9. The stated intention of extending a firm's assessment of the appropriateness of the use of a QMMF is helpful and brings this into line with the firm's assessment of banks used to hold client money. We do however have two related observations:
(1) Some firms in the past have considered the rules on the use of QMMFs to extend to client-directed investments, i.e. where a client makes their own investment decision to instruct the purchase of QMMF units. We consider that guidance to make clear that the CASS 7.13 rules in respect of QMMFs relate solely to situations where the firm itself makes the decision to place client money into a QMMF (and not to individual clients' investment decisions).
(2) We note that the proposed new guidance at CASS 7.13.20-A G (1) brings money invested in a QMMF into the scope of client money diversification. We also note that CASS 7.13.26R continues to make clear that any such investment in a QMMF will result in the units or shares falling within the scope of CASS 6. We consider that this potential conflict may result in (a) firms 'double counting' such QMMF investments as both client money and custody assets (leading to discrepancies with records, reconciliations and CMAR submissions) and/or (b) firms failing to distinguish between (i) client money invested by the firm in QMMFs and (ii) client investments directly in QMMFs as an asset (and not as part of a client money diversification strategy).

10. We agree that requiring express consent from clients when depositing client money in a QMMF is a sensible measure, however we reiterate the point above that a distinction should be made through additional guidance in CASS 7.13 that these particular rules only apply where a firm is making the decision to place client money into a QMMF.

11. We acknowledge that MiFID II permits the placement of a greater proportion of client money within in a group bank under certain circumstances and that the FCA does not wish to gold-plate the requirements. We do consider that there is scope for such firms to expand and move classification from a CASS small firm to a CASS medium firm; alternatively it may be that a better solution is to set a monetary threshold on client money balances rather than whether the firm is classified as small. Some medium and large firms may only have small client money balances and could benefit from the relaxation in the rule.

12. We welcome the clarification around the way in which firms need to consider the settlement of trades and the risk of settling one client's trade with other clients' assets. We consider that further guidance around:
    (1) the use of commercial settlement systems such as CREST which use order queues at the Participant ID level (i.e. the firm and not the underlying client orders) can lead to the systemic use of one client's assets to settle another's trade; and
    (2) that the simple inclusion of disclosures required by COBS 6.1.7R in the firm's term of business on the nature of omnibus accounts may not be sufficient to meet the 'express prior consent' requirement.
    If, for example, the FCA considers express prior consent to represent an explicit separate sign-off against this specific risk (rather than for the fact that such a situation may arise being included as one clause within the firm's standard terms), we would welcome this clarification. Our members have had a number of discussions on this subject with a wide variety of firms over the past few years in the context of their CASS audits and we consider there to be a wide variety of approaches across financial services firms at present; accordingly, we do not agree with the CBA as this is likely to impact upon a number of firms business models in respect of trade settlement. In particular, firms relying on CREST and trading for clients through a single PID are likely to incur increased costs for intraday trade monitoring and through the need to tie up the firm's own capital in covering shortfalls caused by failed trades.

13. According to changes proposed to CASS 1A.3 regulated firms must allocate responsibility for CASS oversight to a single director or senior manager of sufficient skill and authority and the firm must ensure that it does not allocate any other responsibilities to that person unless the two conditions set out in the draft rulebook are met. We would welcome further clarity from FCA and additional guidance as to when it would be more appropriate for the CF10a to have more senior responsibilities. In particular, we note that for the most complex global firms it may be beneficial for the CF10a / SMF18 to occupy a more senior role with additional European or Global responsibilities in order to have the standing and authority within the firm to execute their CASS duties and responsibilities.
    We note that potential developments in senior managers' regime applying to investment management business will have to be taken into consideration in the future too. Given the ongoing implementation of the senior manager and certification regime, we would suggest that consideration be given to a single job title defined within the rules (such as 'CASS Oversight Officer' or similar) encompassing the current CF10a position, the appointed director/senior manager at a CASS small firm and the SMF 18/SMF 22 roles in respect of CASS oversight with a Glossary definition explaining the scope.

14. We note that the additional proposed guidance at CASS 6.6.5G (2) states that compliance with the whole of CASS 6.6 (as applicable to the firm) will be sufficient to comply with CASS 6.6.3R; we consider that this raises a corresponding question as to whether any CASS 6.6 breach therefore leads to a consequential CASS 6.6.3R breach.

15. CASS 6.4.1CR (3) requires the regulated firm to take appropriate measures to prevent the unauthorised use of safe custody assets by close monitoring and prompt requests of undelivered assets. We would welcome clarification around what the FCA means by 'close monitoring' of settlements as this will vary depending on the jurisdiction the assets are being traded in and the information available from our sub-custodians.