II-Annex 3: Client Asset Protection in Resolution

This Annex provides guidance on the interpretation and implementation of the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the '*Key Attributes*', KAs) relating to elements in resolution regimes that are necessary to resolve a financial firm with holdings of client assets (hereafter "firm"). The *Key Attributes* state that the legal framework governing the segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of firms and should not hamper the effective implementation of resolution measures (KA 4.1). Effective resolution regimes should allow for the rapid return of segregated client assets or the transfer to a performing third party or bridge institution of the client asset holdings.

This Annex supplements, and should be read in conjunction with, the *Key Attributes* in relation to any financial firm that directly or indirectly holds client assets and that could be systemically critical or important in the event of failure.[32]

National regimes for client asset protection vary significantly in the methods by which client assets are protected because such protection depends on the particularities of the laws defining property rights and resolution and insolvency regimes in each jurisdiction. Client asset protection regimes fall into a number of broad categories which have been classified by IOSCO as 'custodial regimes', 'trust regimes' and 'agency regimes,[33] based on the legal nature of the relationship between the firm and its clients with respect to client assets. Those differences are likely to affect the legal nature of the client's rights to its assets, the way in which those rights are protected by the regime and the treatment in insolvency. Moreover, the definition of a 'client asset' that is subject to a particular form of protection and rights for the client varies across jurisdictions.

Client assets are held by different types of firms in the course of different financial activities and services, including safeguarding, administration and custody, investment services and brokerage, prime brokerage and collateral taking in connection with other financial transactions. The regulatory classification of those different types of firms varies across jurisdictions.

The legal and contractual arrangements by which client assets are held and the permissible use, if any, of those assets by the firm or third parties may also differ depending on the type of firm holding the assets and the activities in question. For example, in some jurisdictions prime brokers have and exercise contractual rights to re-hypothecate and use some of the client assets that they hold. By contrast, custodians generally hold, administer and safeguard securities on behalf of clients.

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[32] Where components of this Annex have been deemed important for purposes of assessing compliance with the *Key Attributes*, those components are explicitly reflected in the Key Attributes Assessment Methodology.

[33] Introduction to the Final Report of the IOSCO Technical Committee on Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets (March 2011). http://www.iosco.org/library/pubdocs/pdf/IOSCOPD351.pdf

The Technical Committee and, later, the Board of IOSCO have issued a number of reports pertaining to client asset protection: namely the Report on Client Asset Protection (August 1996);[34] the Final Report on Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets (March 2011);[35] and the Final Report on Recommendations Regarding the Protection of Client Assets (January 2014).[36] The recommendations and principles regarding standards of client asset protection, including those relating to safeguarding, administration, management, and the deposit of client assets in a foreign jurisdiction, waivers of client asset protection, rights of use and disclosure to clients are relevant to and support the guidance set out in this draft Annex. This draft Annex relies upon those IOSCO standards to specify in further detail how the principles in the Annex relating to the safeguarding and identification of client assets, use of assets and transparency to clients should be met.

Given the significant variations in national regimes for client asset protection, the draft guidance is intended to specify outcomes rather than prescribe methods or mandatory rules by which those outcomes should be achieved. Whatever national arrangements apply, client assets should be shielded - in a manner appropriate to those arrangements - from the failure of the firm and, to the extent possible, of any third party custodian.[37] The legal status of client assets and the clients' entitlement to them should not be affected by entry into resolution of the firm.[38]

1. Scope

1.1 This Annex applies to resolution regimes for firms within the scope of KA 1.1 that are holding client assets.

2. Objectives (Preamble and KA 2.3)

2.1 The resolution authority or an administrator in charge of the resolution of a firm with holdings of client assets should, in the exercise of its resolution powers, be guided by the following specific objectives related to the protection of those assets (in addition to the general objectives set out in KA 2.3):

(i) ensuring prompt access for the firm's clients to their assets through the continued functioning of the firm following stabilisation in resolution, the rapid return to the client of identifiable and segregated client assets or the transfer of

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[34] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD57.pdf

[35] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD351.pdf

[36] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD436.pdf

[37] Although it is generally possible to ensure that client assets placed with a third party are shielded from the failure of the third party, this is not always the case: for example, client money deposited in a bank could be affected by the failure of that bank.

[38] In some jurisdictions, the fact that assets are held through and in the name of a financial intermediary does not alter the client's ownership interest.

the client asset holdings of that firm to a performing third party or bridge institution; and

(ii) avoiding adverse impacts that might arise from lack of access for clients to their assets.

2.2 The objectives related to protection of client assets should be reflected in the mandate and objectives of the resolution authority or of the administrator in charge of the resolution of the firm. They should be balanced with other objectives of the resolution authority or administrator, as appropriate in the circumstances of the specific case.

3. Definition of client assets

3.1 For the purposes of this guidance, client assets should be interpreted broadly to include all assets that are treated as client assets and subject to protection as such under applicable national law or regulation. Typically, they are assets held by a firm (whether or not through a custodian) for or on behalf of a client in the course of or in connection with services provided by the firm to the client. Client assets typically include assets to which the client (or clients collectively) has (or have) a proprietary or similar right to the return of those assets,[39] subject to any right of the firm to those assets as collateral (for example, security interests, netting or set-off, as applicable). Client assets typically include:

(i) money held on behalf of or owed to a client by a firm that is classified as "client money" under applicable national law;[40]

(ii) financial instruments or other assets held for or on behalf of a client;

(iii) client collateral, that is, assets received from a client and held by a firm for or on behalf of the client to secure an obligation of the client (other than under a title transfer transaction, see paragraph 3.2 (iii)); and

(iv) assets and other (contractual) rights arising from transactions entered into by a firm on behalf of a client (for example, mark-to-market accruals arising from the change in value of futures and options positions).

3.2 For the purposes of this Annex client assets are not considered to include:

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[39] Where the assets are held on dematerialised basis, the right might be to a quantity of a particular security referred to for example by its CUSIP (Committee on Uniform Security Identification Procedures) number or ISIN (International Securities Identification Number).

[40] The classification and treatment of money held on behalf of, or owed to, a client varies between jurisdictions. In some jurisdictions, clients may have a direct ownership interest in segregated cash balances, and in this case the money is treated as "client money", and may be subject to specific forms of protection. In others, cash balances qualify as mere claims against a firm and as such would not be covered by this Annex.

(i) deposits held by banks (as 'deposits' are defined for the purposes of the regulation of the activity of taking deposits under applicable law), unless the deposits held by a firm with a bank constitute customer funds under the applicable legal framework and are labelled as such;

(ii) assets held by an insurer or policyholder claims and rights in connection with insurance business; and

(iii) assets delivered in a full title transfer transaction, such as securities lending transactions, repurchase or reverse repurchase agreements, where neither the client nor clients collectively retain proprietary or similar rights to the assets.[41]

3.3 The legal framework should include clear and transparent rules on how:

(i) client assets are defined, including the classification of securities held for or on behalf of a client and (where applicable) client money; and

(ii) client assets are treated in the event of failure of the firm that holds the client assets either directly or indirectly (through one or more intermediaries or custodians).

4. Transfer powers in relation to client assets (KA 3.2(vi) and (vii) and KA 3.3) [42]

4.1 The powers set out in KA 3.2 (vi) and (vii) and KA 3.3 ("transfer powers") should extend to the transfer of client assets.

(i) In the case of client assets held by the firm in resolution, the resolution authority or an appointed administrator should have the power to transfer the assets and corresponding client contracts to a sound financial institution or bridge institution that, in either case, is capable of providing similar services (a 'qualified transferee'), as an alternative to returning the assets to the clients.

(ii) In the case of client assets held by a domestic affiliate of the firm in resolution, a similar approach should be possible if the viability of the group or domestic sub-group is affected.

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41 This does not preclude jurisdictions from applying forms of client asset protection to such assets or client claims under national law. However, this Annex does not specifically address considerations relevant to the treatment of such assets or claims in resolution.

42 The use of transfer powers may vary according to whether the assets are held by the firm in resolution or by an unaffiliated third party custodian. In the former case, transfer from the firm in resolution (or rapid return of the assets to clients) is likely to be the most appropriate action. However, where the client asset holdings of a firm in resolution are held by a third party custodian, transfer of the assets is not likely to be necessary. The resolution authority may instead transfer the contractual rights and obligations between the firm in resolution and its clients to the successor firm or bridge institution. Separate considerations may apply if the assets are held by a firm that is affiliated to the firm in resolution, if the viability of the group is affected.

(iii) In the case of client assets held by a third party custodian, the resolution authority should have the power to transfer the contractual rights and obligations between the custodian, the firm in resolution and its clients to the qualified transferee.

4.2 Transfer powers should enable the resolution authority to transfer entire business lines and related client assets to a qualified transferee and should not require the consent of affected clients.

4.3 The exercise of transfer powers should be subject to the relevant safeguards set out in KA 5.

4.4 The exercise of powers to transfer or achieve a rapid return of client assets should be supported, to the extent consistent with the national legal framework, by:

(i) expedited court approvals, where these are necessary (consistent with KA 5.4 and 5.5);

(ii) protection in law for resolution authorities, their employees or appointed administrators against liability for actions taken and omissions made while acting within their legal powers and discharging their duties in good faith;

(iii) the availability of investor protection or similar industry backstop funds to support transfers of client assets or to make advance payments of client funds and delivery of securities;

(iv) mechanisms for later adjustments to deal with disputed claims in relation to assets that have been transferred; and

(v) the ability of the resolution authority or appointed administrator to adopt pragmatic approaches to the transfer or return of client assets (for example, advance distributions, piecemeal returns, returning substitute assets).

5. Identification, safeguarding and segregation of client assets (KA 4.1)

5.1 Firms should be required to maintain effective arrangements, such as segregation, for the identification and safeguarding of client assets so that resolution authorities or administrators are able to identify quickly which assets are client assets and to ascertain the nature of claims and entitlements of individual clients to those assets, including with respect to client assets held in a holding chain.

5.2 Clients should be adequately informed about the way their assets are held, including the type of segregation and the existence of any holding chain, and the applicable client asset protections. That information should include in particular the effects of pooling of client assets in omnibus client accounts in the event of the insolvency of the firm or any custodian, how any shortfall in pooled assets will be allocated; and, where relevant, the fact that the regime for client asset segregation and protection may be different under foreign law, and that the client may not receive the same level of protection available under domestic law.

6. Securities financing transactions, re-hypothecation or use of client assets (KA 4.1)

6.1 Jurisdictions that permit securities lending by firms as agents for clients or re-hypothecation and use of client securities by the firm or third parties as principal should adopt clear frameworks governing those arrangements.

(i) Where a firm lends client securities as agent, it should keep adequate records of outstanding transactions, including counterparties, contract terms, legal documentation, collateral details and location of collateral. Those records should be sufficient to enable clients to unwind outstanding transactions to which they are principal or, in the event of resolution, to enable outstanding transactions to be transferred to a qualified transferee. Particular consideration should be given to ensuring that the firm holds adequate records of collateral allocation where securities collateral is held for multiple clients on a pooled basis and where cash collateral is reinvested on a pooled basis.

(ii) Where a firm re-hypothecates or otherwise uses client assets as principal, it should keep clear records of which client assets have been re-hypothecated or used. In particular, in order to facilitate resolution, it should be clear how the exercise of the right of use is recorded[43] and what quantity of assets can be re-hypothecated or used.

6.2 Where the legal framework permits securities lending, rights of use, re-hypothecation or similar arrangements in respect of client assets, it should require adequate disclosure to clients of the effects of such transactions on the protection of their assets and the nature of their legal claims in resolution.

7. Shortfalls in client assets and use of protection funds (KA 6)

7.1 Jurisdictions should have in place clear rules on how losses are shared between clients in the event of shortfalls in a pool of client assets. Their application should not unduly delay or prejudice the objective of a rapid return or transfer of client assets.

7.2 There should be clarity as regards the role of investor protection schemes and other guarantee schemes or funds supporting the transfer of client assets and addressing shortfalls.

7.3 When an investor protection scheme may also be used in connection with resolution measures, there should be safeguards to avoid an excessive depletion of the protection scheme for the financing of resolution measures not directly aimed at the protection of client assets.

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[43] For example, by debiting the account of the client and crediting the account of the collateral taker, or by a form of notification on the client account.

8. Cross-border issues (KA 7)

8.1 Home and host resolution authorities should provide each other with the relevant information on:

(i) the operation of their domestic client asset protection regimes;

(ii) the resolution measures and other actions that can be taken at national level in the event of a firm's failure and their impact on the ownership status and the clients' rights in relation to the assets; and

(iii) available mechanisms to achieve a rapid return or transfer of client assets.

8.2 Jurisdictions should develop:

(i) cooperation arrangements that complement effective resolution strategies and plans and that facilitate a rapid return of clients assets held in their jurisdiction, including procedures for timely recognition of the appointment of an administrator to a foreign firm with holdings of client assets in their jurisdiction; and

(ii) expedited mechanisms to give effect to transfers by a foreign resolution authority (acting directly or through a special administrator, receiver, conservator or other official) of client assets held in their jurisdiction, which may consist of the recognition of foreign transfers or the exercise of transfer powers by the local resolution authority or administrator to transfer such client assets or the contract between the foreign firm in resolution and a domestic intermediary that holds client assets on behalf of the foreign firm in resolution.

9. Resolution planning and actions to promote resolvability (KA 10 and KA 11)

9.1 Resolution planning for a firm holding client assets should consider the following:

(i) arrangements in place within or involving the firm that ensure that the identity of clients and their assets can be established rapidly;

(ii) the legal or procedural requirements for the transfer of client assets or of the contracts governing the holding of, or custody arrangements for, client assets;

(iii) the type of segregation and its impact on rapid return or transfer of client assets;

(iv) any re-hypothecation arrangements and rights of use that may be exercisable, and the impact of the exercise of such rights on the ability to transfer or recover and return assets;

(v) the scale of lending of client assets by the firm as agent, including the following features:

- the maturity structure of the book and how quickly it could be unwound,
- the liquidity of any cash collateral reinvestment and whether that could impede a rapid unwinding of the book,
- how any cash collateral is reinvested (for example, whether on a pooled or segregated basis),
- how any securities collateral is held (for example, whether on a pooled or segregated basis),
- the quality of the firm's records of outstanding securities lending transactions, particularly where collateral is held on a pooled basis, and
- what information is provided to clients and how frequently;

(vi) the effect of correlated failures on the resolvability of the firm, where a custodian, sub-custodian or other intermediary in the holding chain is an affiliate of the firm and is itself in resolution or insolvency;

(vii) where client assets are held in another jurisdiction, the effect of foreign law on the nature of the protection of client assets and their treatment in insolvency, to the extent necessary for resolution;

(viii) how shortfalls in client assets and resultant client claims are treated in the resolution and how losses to clients will be allocated;

(ix) the role of investor protection schemes or other guarantee schemes or funds to support transfers of client assets or to make advance payments of client funds and delivery of securities; and

(x) cooperation and information sharing arrangements with relevant foreign authorities to support the rapid return or transfer of client assets where those assets are held in a foreign jurisdiction.

9.2 To support the effective exercise of transfer powers, resolution authorities should have the power to require changes to a firm's business practices, information management systems and contractual arrangements relating to the holding and protection of client assets.

10. Information requirements and record keeping (KA 12.2)

10.1 In order to facilitate the rapid transfer or return of client assets, firms should be required to maintain information systems and controls that can promptly produce, both in normal times and during resolution, and in a format understandable by an

external party such as a resolution authority or an administrator, information on the following:[44]

(i) the amount, nature and ownership status of client assets held directly or indirectly by the firm;

(ii) the identity of the clients;

(iii) the location of the client assets, how the assets are held (that is, by the firm, an affiliate or third party custodian or sub-custodian) and the identity of all relevant depositories;

(iv) the terms and conditions on which the client assets are held, including contractual arrangements between the firm and the client and any third party holding the client assets;

(v) the type of segregation ("omnibus" or "individual"), if applicable, at all levels of a holding chain and the effects of the segregation on the clients' ownership rights;[45]

(vi) the applicable client asset protections, in particular where client assets are held in a foreign jurisdiction and will be subject to the client asset protection and resolution or insolvency regime of that foreign jurisdiction, and any waiver, modification or opting out by the client of the client asset protection regime (where permitted by the applicable regime);

(vii) the ownership rights of the clients and any potential limitations to those rights, including the existence of liens or other encumbrances that may affect the return of such assets or their value to clients, and the firm's obligations with respect to the client assets;

(viii) the existence and exercise of any rehypothecation or rights of use by the firm, including details of the assets that have been re-hypothecated or used and the legal consequences of the exercise of those rights on the clients' rights over those assets; and

(ix) outstanding loans of client securities arranged by the firm as agent, including details of counterparties, contract terms and collateral received on behalf of the clients.

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[44] Record keeping requirements should be guided by the IOSCO Recommendations Regarding the Protection of Client Assets: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD401.pdf

[45] In some jurisdictions, segregation of client assets from the firm's proprietary assets may directly affect the clients' rights to the assets. In others, segregation does not affect those rights, but facilitates identification and recovery of client assets.

11. Impediments to orderly resolution

11.1 Resolution authorities should inform the relevant supervisory authorities if their resolvability assessments indicate that that client asset protection regime could impede orderly resolution and the rapid return or transfer of client assets. Supervisors should consider appropriate modifications to that regime or other actions to address the reported impediments.