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Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
Sent by e-mail to: fsb@bis.org

Re. Financial Stability Board Consultative Document, *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions*, Annex to the Key Attributes: Client Asset Protection in Resolution, August 12, 2013

To the Financial Stability Board:

The Institute of International Finance (IIF) welcomes the opportunity to comment on the Annex to the Key Attributes: Client Asset Protection in Resolution (the "Consultative Report") prepared by the Financial Stability Board (FSB) and issued in August 2013. The importance of establishing a clear, transparent and enforceable legal framework for the treatment of client assets should not be underestimated. Indeed, a successful resolution, with limited systemic effects, will likely be dependent on clients having timely access to their assets.[1] The IIF supports the FSB's general efforts here and is broadly in agreement with the scope, content and goals of the report. Thus the focus of these comments will largely be on general themes.

The *Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (the "*Key Attributes*") placed significant emphasis on client-asset protection and the treatment of such assets in resolution. Broadly speaking, the *Key Attributes* addressed the issue in two ways: first, it stated that the resolution process should ensure the rapid return of segregated client assets;[2] and second, it recommended that the legal framework for client-asset treatment be clear, transparent, and enforceable.[3] Particular attention was also given to certain types of clients, namely insured depositors, insurance policy holders, and retail customers.[4] Beyond this, it was not entirely clear what was expected of authorities or from firms in this area, and many questions were left unanswered. This Consultative Document helps clarify several of these issues, particularly the type of information that should be provided to clients. It also seems to be in general accordance with the *Key Attributes*, and is consistent with earlier guidance on the topic, including the report titled *Recommendations Regarding the Protection of Client Assets*, published by the International Organization of Securities Commission (IOSCO) in February 2013.

General Comments

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1 However, assets should not be promptly returned to one client at the detriment of other clients.

2 See Preamble, item (ii), under the aims of an effective resolution regime; Key Attribute 3.2(xii), on general resolution powers; and Key Attribute 11.6(v), on the scope of the resolution plan.

3 See Key Attribute 4.1, on the legal framework governing set-off rights, contractual netting and collateralization agreements and the segregation of client assets.

4 See Preamble, item (ii), under the powers given to effective resolution regimes; Key Attribute 3.8(ii), on the ability to apply different resolution powers to different parts of the firm; and Paragraphs 3.2, 4.1(v), and 5.1(ii) under Annex I.

As a general matter, one issue to bear in mind is that the particular contractual arrangements that firms make with their clients, including those relating to protection, segregation and rehypothecation, are intended to be beneficial to both parties. Clients may wish to modify or waive certain rights and protections that would otherwise be given to them, and do so in a way that better meets their business objectives. Indeed, there are often good reasons for clients, especially ones that are institutional, to waive parts of the client-protection regime. While safeguards should be established to ensure that these rights are not disregarded, sophisticated clients should still be able to enter into appropriate and mutually beneficial arrangements with firms. Many of these issues, especially rehypothecation, are being addressed directly in connection with derivatives reforms or other areas of substantive reform. Provisions with respect to resolution should not duplicate or complicate such other bodies of law and regulation.

It is important also that any necessary changes to the client-protection framework be done in a way that minimizes the potential adverse effects on competition and that allows firms to offer appropriate financial services to their clients. Improving the client-protection regime is vital for the safety and soundness of the financial system, but at the same time firms should be able to provide clients with innovative products and services. In particular, improvements in the efficiency for managing client assets, while done safely and in compliance with other bodies of regulation, will help lower costs and lead to greater benefits for clients. The notion of any tradeoff between efficiency and safety is misguided; instead, progress in the treatment of client assets from an efficiency standpoint will likely result in a stronger, more secure method for handling those assets.

The report correctly identifies transparency and clarity as being important elements of an effective client-protection regime. This is partly so that clients are able to educate themselves about the risks associated with their investments. Responsibility for the protection of client assets rests not only with firms and with resolution authorities, but with clients as well. While clients should be "adequately informed about the way their assets are held, including the type of segregation and the existence of any holding chain," as the report notes, it is also up to those clients to internalize that information and make informed decisions on the basis on that information. An appropriate allocation of responsibility to clients is necessary, if for no other reason than to help minimize moral hazard. Clients should have incentives to consider carefully the risks they are able to take and to monitor those risks they have willingly assumed.

As the report indicates, one complication that arises here is the variation in the different types of national regimes, including the "custodial-," "trust-," and "agency-based" models mentioned. This is unfortunately an issue that cannot be avoided, though as noted, the important point is that there be general consistency in outcomes across borders. Thus, the report is appropriately outcome-oriented, rather than prescriptive. Of course the type of national regime adopted will have consequences for the client's legal rights to its assets, the protections given to those assets, and their treatment in insolvency; but so long as the particular outcomes specified in the Annex are achievable and are met, these differences should not pose any serious problems for resolution purposes.

To be clear, greater harmonization and cross-border consistency would certainly be preferable.[5] This is true particularly with respect to the terms on which client assets can be pooled in omnibus accounts at clearing houses (to facilitate use of pooling where appropriate under reasonable conditions), and the terms on which individual client accounts are offered. There are differences in national legislation on client-asset pooling and segregation and the treatment of excess margin provided by clients that are likely to cause confusion and operational issues, and create inefficiency in the long run. Similarly, portability rules are evolving with differences. These are issues that will not necessarily be easy to harmonize, given different contexts in different countries but, as always with such issues, the payoff to getting it right – to achieving workable, clear, and internationally consistent standards – would be great. Particularly in the context of FMIs,

[5] The FSB, for example, should work to assure consistency with other relevant proposals in the field, including the UK Financial Conduct Authority proposal CASS CP13/5.

clear, consistent, and generally understood rules will be essential to the smooth operation of cross-border resolution and the avoidance of unfair or anomalous results. Thus, the FSB and the international community should put a high priority on the convergence of such rules, the establishment of principles of mutual recognition, and the removal of any inconsistencies in such rules that would operate as impediments to quick and effective resolution with seamless restoration of critical functions if at all possible.

Issues involving client-asset protection cannot be considered on the own as independent matters, but must be fit into the broader legislative framework of securities and investor-protection laws. In addition, not all activities involving client assets are alike, and client assets are held by different types of firms performing different services including administration and custody, asset management investment services, brokerage, and prime brokerage, among others. Client assets are moreover often held through numerous layers of such functions. Each raises its own set of legal and operational challenges with respect to client-asset protection. As noted above, focus on resolution is essential, and it is essential to make sure that such laws will contribute to efficient and fair outcomes in resolution, especially of an FMI but also of other firms in the chain of custody; conversely, the resolution regime should be a complement to, and not a determinant of, the policy issues with respect to the appropriate regulation of client assets at each link in the chain. Similarly, the terms and conditions of a client's return or transfer of assets will be determined by the contractual arrangements and legal regime applicable at each layer of custody, which should not be interfered with by resolution provisions applicable to the various intermediary entities.

Specific Comments

While the IIF agrees that the term "client assets" should be interpreted to include all assets that are held in custody and therefore should be subject to protection, the Consultative Report states that such assets are those "where the client has a proprietary or similar right to return of the asset or its substitute." The current definition of "client assets" contained in the paper does not draw a clear enough distinction between:

(1) in respect of client securities held at all times in custody, the proprietary right of a client to the return of such securities - it being understood that because most securities are held on dematerialized basis, clients retain an individual proprietary claim to interests in a pool of fungible securities; and

(2) in respect of client securities which have been rehypothecated, the contractual right of a client to return of "equivalent securities" of an identical type, nominal value, description, class and amount.

To the extent that rehypothecated client securities are included in the definition of client assets, it seems reasonable to assume that they would only be included for purposes of record keeping, reporting and disclosure in accordance with applicable law and relevant agreements, and not for the purpose of any of the other sections of the Appendix. If this is the case, the IIF would be grateful if the FSB would clarify and confirm this in the document.

Further, the client may not be entitled to the return of some or all of the securities or equivalent securities as its account may, for instance, be subject to a security interest or netting or set-off provision which would extinguish such right of return upon a client default. It is important that such contractual (or statutory) arrangements be respected and that the definition of client assets take into account any arrangements which result in the loss of a client's proprietary or contractual right to return of the securities or equivalent securities.

There have already been discussions with, and submissions made to, the FSB with regard to this matter in connection with the FSB's Workstream 5 on Securities Lending and Repos.[6] It is important that the concepts of:

> (1) "rehypothecation" of client assets (i.e., the legal act of transferring title to or rights in a client asset from a client to a firm and thereby subordinating or extinguishing any proprietary interest that the client may have in the asset, which in many cases thereby becomes an asset of the firm); and
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> (2) "reuse" of such rehypothecated assets (i.e., the subsequent use by a firm of a rehypothecated client asset in order to raise financing for, or as collateral for any hedging undertaken to cover, client transactions or other transactions pursuant to applicable law and agreements)

be clearly defined in any FSB papers and be consistently applied to any analysis of client asset protection.

The FSB has taken a commendable step forward in attempting to address these issues through the Appendix, though there remain areas where further consideration is needed. For example, the proposal is constructive in its approach to cross-border cooperation, but, as the FSB recognizes, there needs to be more clarity as to how cooperation will work with respect to client assets. The IIF would ask that the matters raised above be considered in greater depth as the FSB continues its work in this field, and of course the IIF would be happy to organize any discussions with industry experts that may be useful to that effort. Should you have any questions on the issues raised in this letter, please contact Alec Oveis (aoveis@iif.com; +1 202-857-3615).

Very truly yours,

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[6] The FSB Resolution Steering Group should consult with, and adopt a consistent position to, that of Workstream 5 of the FSB Consultation on Shadow Banking , titled "A policy framework for addressing shadow banking risks in securities lending and repo" (Nov. 18, 2012), which specifically looks at rehypothecation.