



CONSULTATION PAPER NO. 61

APRIL 2009

**PROPOSED ENHANCEMENTS TO
CLIENT ASSET PROTECTIONS**

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Why are we issuing this paper?

1. This Consultation Paper seeks public comments on the DFSA proposal to make changes to certain rules which are designed to protect Client Assets when held or handled by Authorised Firms or their agents. The proposed changes are designed to enhance the current protections and to address recent regulatory developments and risks. The opportunity is also taken to propose various miscellaneous amendments including one to remove an unintended consequence in the current rules on safeguarding and administration.

Where can the changes be found?

2. This paper details proposed changes to the following parts of the DFSA Rulebook:
 - (a) Conduct of Business (COB) chapters 6.11 to 6.13 and COB App5 and App6 (see Appendix 1 to this paper);
 - (b) General Module (GEN) section 8.6 (see Appendix 2); and
 - (c) Consequential changes to the Glossary Module (GLO) resulting from the proposed changes (see Appendix 3).

Who should read this paper?

3. The proposals in this paper would be of interest to Persons:
 - (a) carrying on, or considering carrying on, Financial Services in or from the DIFC;
 - (b) Providing or Arranging Custody;
 - (c) Managing Assets or Operating a Collective Investment Scheme; and/or
 - (d) holding Client Money and/or Client Investments.

How is this paper structured?

4. In this paper, we set out:
 - (a) the background to the proposals (paragraphs 8-11); and
 - (b) the proposed changes to the Client Assets regime (paragraphs 12-29).

How to provide comments?

5. All comments should be forwarded to the person specified below. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

What happens next?

6. The deadline for providing comments on the proposals is **25 May 2009**. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to enact the changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We will issue a notice on our website telling you when this happens.

Comments to be addressed to:

Matthew Shanahan
Legal Counsel
Policy and Legal Services
DFSA
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Dubai, UAE

04 3621511 or e-mailed to: MShanahan@dfsa.ae

Terminology in this paper

7. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in GLO or in the proposed amendments. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

Background

8. Principle 9 of the Principles for Authorised Firms (Customer assets and money) requires an Authorised Firm to arrange proper protection for clients' assets when the firm is responsible for them. The protection of Client Money and Client Investments (together **Client Assets**) when held or controlled by Authorised Firms has been a core aspect of our COB Rules since 2004.
9. In summary, the relevant Client Asset provisions impose key requirements on Authorised Firms to segregate and safeguard Client Assets, to perform due diligence when transferring those assets to a third party and to keep adequate records. These key requirements help to constrain an Authorised Firm in the way it handles Client Assets and makes it clear to third parties that the assets are not the Authorised Firm's. If an Authorised Firm becomes insolvent, the Client Assets do not constitute part of the insolvent firm's estate. They are thus protected from claims by creditors of the Authorised Firm. This is particularly important in times of economic downturn when corporate insolvencies tend to increase.
10. The recent identification by US authorities of certain high-value investment frauds have brought to the DFSA's attention the need to review relevant Rulebook provisions to ascertain whether there is scope to further reduce the risk of detriment to Clients, particularly in the investment management sector.
11. Whilst fraud can never be entirely eliminated, periodic oversight conducted by an independent third party can materially reduce the likelihood of a fraud going undetected.
12. In this context, we have reviewed the Rulebook requirements we impose on firms which Manage Assets, Provide Custody or Arrange Custody. These Client Asset requirements are in sections 6.11 to 6.14 and Appendices 5 and 6 of the COB Module and section 8.6 of the GEN Module.
13. In reviewing the Client Asset regime the DFSA has examined approaches adopted in comparable jurisdictions and, in particular, the EU's Markets in Financial Services Directive (**MiFID**) provisions on the protection of client assets.

Proposed enhancements

14. The key changes proposed are:
 - (a) The removal of the Client Money opt-out provision (the **Opt-Out**) for all Professional Clients other than Market Counterparties;
 - (b) The requirement for all firms which hold or control Client Investments to be subject to our Safe Custody Provisions;

- (c) The requirement for all firms which hold or control Client Assets, Provide Custody or Arrange Custody, to be subject to an audit requirement in respect of those Client Assets; and
- (d) A number of miscellaneous amendments including amendments to clarify various Client Asset requirements and to remove an unintended anomaly in the Safe Custody Provisions.

The Opt-Out

- 15. An Authorised Firm which holds or controls Client Money for a Client must comply with the Client Money provisions in COB 6.12.2, including Appendix 5 of the COB Module. Our Client Money provisions contain various requirements in respect of:
 - (a) the payment of Client Money into or from Client Accounts;
 - (b) Client Account to be held by a Third Party Agent;
 - (c) maintenance of a Master List of all Client Accounts;
 - (d) Client Disclosure and Client Reporting;
 - (e) conducting reconciliations; and
 - (f) Client Money Distribution Rules.
- 16. However, under COB Rule 6.12.2(2), an Authorised Firm does not currently have to comply with the Client Money provisions in respect of a Professional Client where it has obtained the prior written consent of that Client. Professional Client is defined in COB 2.3.2 to 2.4.1 and includes a Market Counterparty.
- 17. We propose to remove the ability for Authorised Firms to allow Professional Clients (other than Market Counterparties) to opt out of the Client Money Provisions. We consider that the benefits of the Client Money Provisions outweigh the compliance costs. Apart from enabling the proper segregation and identification of Client Money in the event of an administration or insolvency, the Client Money Provisions help to reduce the risk of fraud.
- 18. Our proposal in regard to the Opt-Out was made after benchmarking against the relevant MiFID provisions and the UK's implementation of this particular directive. Whilst MiFID provides no explicit exemption from the requirement to safeguard client money, it does leave some flexibility regarding the treatment of certain monies received by firms under title transfer arrangements.
- 19. We propose, therefore, to simply retain the Opt-Out for Market Counterparties rather than prescribing title transfer arrangements. This is because Market Counterparties are better able to understand the associated risks and to manage their credit risk. However, this would of course only apply to money belonging to the relevant Market Counterparty and not to the money of a Market Counterparty's clients which, in accordance with COB Rule 6.12.2(2), cannot be opted-out.

Issues for consideration

Do you have any concerns about the removal of the Opt-Out for Professional Clients (other than Market Counterparties)?

Extension of Safe Custody Provisions to all firms holding Client Investments

20. The DFSA currently prescribes high-level requirements for firms which hold or control Client Investments. That is, under COB Rule 6.13.2 an Authorised Firm which holds or controls Client Investments must have systems and controls in place to ensure the proper safeguarding of Client Investments.
21. Firms which Provide Custody or Arrange Custody are required to comply with the Safe Custody Provisions in COB App6. The Safe Custody Provisions prescribe certain additional requirements on firms in relation to recording and registration of title, Client Accounts, third party custody and client reporting. The requirements are by no means onerous and are simply good practice for firms which safeguard Client Investments
22. The risks to clients from firms which hold or control Client Investments are broadly similar to those where firms Provide Custody and therefore require the same key protections afforded by the Safe Custody Provisions.
23. In order to better reflect risk and to level the playing field between firms which hold Client Investments and those Providing Custody we are proposing to extend the application of the Safe Custody Provisions to firms which hold or control Client Investments.

Extension of Safe Custody Auditor's Report to firms holding Client Investments

24. The Rules in GEN require an Authorised Firm to appoint an Auditor to undertake periodic audits and to produce regular reports. The Authorised Firm must take reasonable steps to ensure that the relevant audit staff of the Auditor are independent of and not subject to any conflict of interest with respect to the Authorised Firm.
25. For those Authorised Firms which hold or control Client Money, GEN Rule 8.6.1(d) requires the firm to arrange for a Client Money Auditor's Report to be submitted to the DFSA on an annual basis.
26. GEN Rule 8.6.1(f) requires an Authorised Firm which Provides Custody to submit a Safe Custody Auditor's Report to the DFSA on an annual basis. Therefore, a Safe Custody Auditor's Report only applies to those firms with permission to Provide Custody. Authorised Firms holding/controlling Client Investments or Arranging Custody which do not also Provide Custody are not required to provide a Safe Custody Auditor's Report to the DFSA on an annual basis.
27. The risks to Client Assets resulting from Providing Custody or holding/controlling Client Investments are largely equivalent so it follows that both should be subject to the same degree of regulatory scrutiny. Additionally,

firms which Arrange Custody have a crucial role to play in ensuring that any Third Party Agent to whom they entrust Safe Custody Assets is and remains suitable. This role requires some independent scrutiny which we believe can be achieved by way of a periodic audit. Therefore, we propose to amend GEN Rule 8.6.1(f) to mandate a Safe Custody Auditor's Report for all firms to which the Safe Custody Provisions apply.

Issues for consideration

Do you have any concerns about the requirement for firms which Arrange Custody or hold Client Investments having to provide a Safe Custody Auditor's Report to the DFSA on an annual basis?

Miscellaneous Amendments

28. The Safe Custody Provisions have the unintended effect that a firm which is authorised to Provide Custody must use a Third Party Agent to hold the Client Investments (see COB A6.4.2). Furthermore, under the DFSA funds regime, an Eligible Custodian which is authorised to Provide Custody would also be subject to this requirement.
29. Therefore we propose to amend the definition of a Client Account in COB A6.4.2 such that firms authorised to Provide Custody are able to do so through a Client Account held with themselves. The requirement to use a Third Party Agent would be retained for firms that are not authorized to Provide Custody.
30. Following a review of COB A5.7.1 (1) (c) (Payment of client money to a third party agent), the DFSA believes that it is necessary to tighten the limited circumstances under which a firm can pass Client Money to a Third Party Agent by clarifying the term "bank" as used in this particular Rule. The DFSA proposes that in the context of safekeeping the term "bank" should be narrowed to ensure that only regulated deposit-taking institutions are used for depositing Client Money. This is to avoid Client Money being held with an unlicensed "investment bank" or a company merely using the word "bank" in its name but without a license for deposit taking.
31. In addition to the changes proposed above, the DFSA proposes to clarify the treatment to be accorded to a firm's money in circumstances where such money is deposited in an account with Client's Money – See Rule A5.3.3 (2) and also the treatment to be accorded to Client's Collateral – See Rule 6.13.5 (a).
32. Rules A5.10.1 (1) and A6.8.1(1) have been modified to cater for both Retail Clients and Professional Clients. Some minor amendments have also been included for convenience, some of these are also the subject of Consultation Paper No. 60. Finally, we have added Guidance to COB 6.11.1 to set out the framework and purpose of the Client Assets provisions.