

# **Survey of Regimes for the Protection, Distribution and/or Transfer of Client Assets**

## **Final Report**



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## Chapter 1 Introduction

In 1996, IOSCO published a report on *Client Asset Protection* (the 1996 Report).<sup>1</sup> The 1996 Report emphasized, among other things, that regulators should “ensure that investors are adequately informed about the arrangements for” protections afforded to Client Assets<sup>2</sup> under their Regimes.<sup>3</sup>

On September 15, 2008, Lehman Brothers Holdings Inc. (Lehman) declared bankruptcy. Simultaneously or shortly thereafter, certain Lehman subsidiaries also declared bankruptcy, including a number of Investment Firms. In the aftermath of such declarations, one thing became evident: clients of the Lehman subsidiaries, as well as applicable regulators, had no means to easily ascertain the manner and extent to which different Regimes, in foreign jurisdictions, protect Client Assets. Thus, the bankruptcies of Lehman and its subsidiaries demonstrated that the goal of investor awareness advocated in the 1996 Report had not been achieved.

This report, including Appendices A and B described below, aims to increase access to information concerning the protections that participating SC3 Regimes offer to Client Assets. Regulators, considering cross-border financial activity, need to understand the methods for, and scope of, protection afforded Client Assets in other jurisdictions, both to fulfil their own responsibilities and to achieve the effective cross-border coordination mechanisms called for in international efforts such as the recent recommendations made by the Financial Stability Board.<sup>4</sup> Market participants, in considering where to do business, need similar information.

Therefore:

- Chapter 2 of this report describes differences in the treatment of Client Assets in various Regimes, based on two issues:
  - (1) distinctions between (i) Securities for which a client has fully paid, and which are free from further pledges and encumbrances (Fully-Paid Securities), and (ii) Securities purchased, in part, with money a customer has borrowed from the Investment Firm (sometimes referred to as “margin securities”); and
  - (2) distinctions between Client Assets securing debts of a client to the Investment Firm (e.g., Securities purchased on margin) and Client Assets serving as a performance bond against the possibility of potential future debts of the client to

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<sup>1</sup> *Client Asset Protection*, August 1996, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD57.pdf>.

<sup>2</sup> Capitalized terms are defined in the attached Glossary.

<sup>3</sup> For example, the 1996 Report stated in Recommendation 3 that “[r]egulatory authorities should seek to ensure that investors are adequately informed about the arrangements for client asset protection within their jurisdictions.” Similarly, the 1996 Report stated in Recommendation 18 that “[r]egulatory authorities should ensure that there is clarity as to the arrangements for protecting client positions held as a result of transactions entered into in their jurisdictions.”

<sup>4</sup> See, e.g., Reducing The Moral Hazard Posed By Systemically Important Financial Institutions (FSB October 20, 2010).

the investment firm (e.g., initial margin for derivatives Positions.) As discussed below, there are related differences in the regulatory treatment of such Client Assets. For analytical purposes, Chapter 2 also divides Regimes into three separate categories – custodian, trust and agency regimes, based on differences in their characterization of the legal relationship between an Investment Firm and its client with respect to Client Assets;

- Chapters 3 and 4 of this report broadly describe the protections that the Regimes afford to Client Assets, both before and after the bankruptcy of an Investment Firm. Such sections differentiate between the categories of Regimes as necessary;
- Appendix A of this report sets out a more detailed chart summarizing such protections;
- Appendix B of this report contains the actual Survey responses from each Regime; and
- Appendix C of this report sets out two related case studies.

A quick perusal of Appendices A and B reveals that each Regime is unique in the methods by which it protects Client Assets, because such protections depend on the particulars of each jurisdiction’s insolvency law and laws defining underlying property rights.

As the 1996 Report notes, “effective client asset protection can be achieved in a number of ways, often through a combination of methods.”<sup>5</sup> Also, as the 1996 Report observes, each Regime may define “effective” differently and may have different priorities.<sup>6</sup> For example, there is tension between precision (e.g., tying losses to customers who hold particular a particular stock in which there is a shortfall) and speed in distributing to customers (or transferring to another intermediary) Client Assets held at an insolvent firm. Different Regimes may weigh these goals differently.

Nonetheless, as the bankruptcies of Lehman and its subsidiaries demonstrated, whether a Regime can effectuate the expeditious transfer or distribution of Client Assets has significant implications for both individual clients and the global financial markets.<sup>7</sup> Consequently, in addition to describing the protections that Regimes generally provide to Client Assets, Chapters 3 and 4 of this report discuss the strengths and weaknesses of particular protections in facilitating efficient transfer or distribution of Client Assets.

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<sup>5</sup> The 1996 Report, p. 8.

<sup>6</sup> Ibid. According to the 1996 Report, “[o]ne aspect of public policy which may differ between jurisdictions is whether the concern within financial markets is to protect the investor or to protect the integrity and efficiency of markets by ensuring the smooth operation of settlement and payment systems.”

<sup>7</sup> Chapter 2 of this report describes such implications in greater detail.

## **Chapter 2 General Observations**

### **A. Differences in the Securities and Derivatives Markets**

The Survey defines Client Assets as encompassing (i) Securities, (ii) Positions, and (iii) Client Money. These three components of Client Assets serve slightly different functions in the securities markets and the derivatives markets. These differences are reflected in the manner in which such Client Assets are treated and protected in each Regime.

#### **A.1 Conceptual Issues Concerning Client Assets in Securities Markets**

Typically, in the securities market, Client Assets consist of: (i) Fully-Paid Securities; (ii) margin securities; and (iii) Client Money.

For margin securities, a balance must be struck between the client's interest in the securities it has purchased, and the Investment Firm's ability to finance the loans it makes to facilitate such purchases. Therefore, the concept of Client Assets with respect to margin securities can often be complex.

Regimes may sometimes treat and protect such Client Assets in different ways. For example, Regimes may require an Investment Firm to segregate<sup>8</sup> Fully-Paid Securities, but not all margin securities. Firms that have margin securities may be permitted to rehypothecate some portion of those securities to finance the loan amount. Where a portion of margin securities may be rehypothecated, some Regimes may require that they be segregated in the Investment Firm's dealings with the lender, while others may not.

If an Investment Firm becomes insolvent, Regimes may (or may not) be able to promptly transfer (to one or more solvent firms) or distribute client Securities, and Client Money. However, there may also be the necessity to procure such margin securities if they are not in the possession or control of the insolvent firm.

#### **A.2 Conceptual Issues Concerning Client Assets in Derivatives Markets**

In derivatives markets, clients enter into Positions, which are essentially contractual obligations to make specific payments, rights to receive specific payments, or rights and obligations to take specific actions (e.g. make or receive delivery) in the future. To guarantee performance of such obligations, clients frequently are required to deposit Client Money and Securities (referred to as "performance bond" or "initial margin") and make incremental settlements, which are referred to in the industry as "variation margin" payments. Once a party's Position is no longer outstanding – either due to final settlement, or earlier, because the Position is offset by an opposite Position – the party is entitled to a return of its initial deposit of Client Money and Securities. There is generally no use of Client Money and Securities to finance client Positions. In the derivatives markets, Client Assets are: (i) outstanding Positions; (ii) Client Money resulting from incremental settlements; and (iii) Client Money and Securities initially deposited to guarantee performance of outstanding Positions.

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<sup>8</sup> This report uses the term "segregation" (and variations thereof) to refer to the practice of an Investment Firm in maintaining Client Assets separately from proprietary assets.

Because clients have rights in the Client Assets described in (i), (ii), and (iii) in the same degree, Regimes may offer similar protections to such Client Assets. For example, Regimes may focus on simultaneously transferring or liquidating the Client Assets described in (i), (ii), and (iii).

## **B. A General Taxonomy of Participating Regimes**

As the 1996 Report states, the methods of protecting Client Assets “may vary considerably from jurisdiction to jurisdiction, reflecting different market traditions, political influences and legal and regulatory systems.”<sup>9</sup> Although, as mentioned above, each Regime offers unique protections for Client Assets, a review of Appendices A and B show that most Regimes may be organized into three general categories. The philosophical differences between such categories, together with the differences between securities and derivatives markets described above, explain much of the variance between Regimes with respect to protections of Client Assets.

- **Custodial Regimes.** Certain Regimes characterize the relationship between an Investment Firm and its client with respect to Client Assets as primarily a custody arrangement under civil law (the Custodial Regimes).
  - Custodial Regimes have developed in jurisdictions where Investment Firms are either permitted or required to be banking entities.
  - Custodial Regimes generally do not require an Investment Firm that is a bank to segregate Client Money.<sup>10</sup> Rather, Custodial Regimes treat Client Money as a general obligation of such an Investment Firm.
  - In contrast, Custodial Regimes do require the segregation of client Securities.
  - Custodial Regimes tend to give maximum effect to the choice of the client to grant full title (or limited incidents of ownership) in client Securities to a solvent Investment Firm. As discussed further below, such grant may lead to shortfalls in client Securities that are not Fully Paid.
  - Custodial Regimes focus on the prompt distribution of Client Assets from an insolvent Investment Firm. For example, Custodial Regimes permit the “preferential” distribution of client Securities (i.e., on terms that are more protective of clients than of other creditors).<sup>11</sup> If there is a shortfall, such Regimes tend to distribute available client Securities *pro rata*, while relying on

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<sup>9</sup> The 1996 Report, p. 8.

<sup>10</sup> While most transactions in Custodial Regimes are intermediated by investment firms which are banks, there are also investment firms which are not banks. Such non-bank Investment Firms are required to segregate Client Money.

<sup>11</sup> While insolvency laws frequently permit an insolvency officer (*e.g.*, a trustee or administrator) to “claw back” assets from creditors who receive “preferential” transfers in the time period immediately before an insolvency (that is, a recovery of more than they would under the insolvency law), many Regimes exempt Client Assets from such claw-back.

compensation schemes to cover limited amounts of shortfalls in client Securities and Client Money.

- By contrast, most Custodial Regimes do not have an overarching arrangement to facilitate the transfer of Client Assets from an insolvent Investment Firm to a solvent Investment Firm. Indeed, certain Custodial Regimes do not permit such transfer.
- Custodial Regimes include: (i) France; (ii) Germany; (iii) Italy; (iv) Japan; (v) Spain; and (vi) Switzerland.
- **Trust Regimes.** Certain Regimes base the relationship between an Investment Firm and its client with respect to Client Assets in equitable principles and the common law of trusts (the Trust Regimes).
  - In general, Investment Firms in Trust Regimes are not banking entities. Therefore, Trust Regimes require Investment Firms to segregate both Client Money and client Securities.
  - Trust Regimes tend to give maximum effect to the choice of the client in permitting a solvent Investment Firm to use (or to *rehypothecate*) Client Assets for example, to aid firms in financing loans made to customers. As discussed further below, such use may lead to shortfalls in Client Assets, for example, where the value of the re-hypothecated assets exceeds the value segregated to replace them.
  - Trust Regimes focus on the prompt distribution of Client Assets from an insolvent Investment Firm. For example, Trust Regimes permit the preferential distribution of Client Money and client Securities. However, Trust Regimes tend to limit such distribution to only those Client Assets that could be definitively traced back to the trust between the Investment Firm and the client.
  - Most Trust Regimes do not have an overarching arrangement to facilitate the transfer of Client Assets. However, such Regimes will permit and encourage such transfer on a case-by-case basis.
  - If there is a shortfall, Trust Regimes tend to distribute available Client Money on a *pro rata* basis, (although the amount available for distribution may also be subject to tracing remedies in some common law jurisdictions such as the UK). Distributions of client Securities may depend on tracing or may be on a *pro rata* basis by, e.g., stock line. Trust Regimes then permit retail clients to claim a limited amount of the shortfall against a compensation scheme. Any shortfall that the compensation scheme does not cover becomes an unsecured obligation of the insolvent Investment Firm.
  - Trust Regimes include: (i) Australia; (ii) Hong Kong; (iii) Singapore; and (iv) the United Kingdom.<sup>12</sup>

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<sup>12</sup> Except for Scotland.

- **Agency Regimes.** Certain Regimes base the relationship between an Investment Firm and its client with respect to Client Assets in a definition of agency that is statutorily created and developed (the Agency Regimes).
  - In general, Investment Firms in Agency Regimes are not banking entities. Therefore, Agency Regimes may require Investment Firms to segregate both Client Money and client Securities.<sup>13</sup>
  - Agency Regimes tend to prohibit solvent Investment Firms from using Client Assets in certain ways, regardless of client directions. Therefore, Agency Regimes tend to prohibit certain practices that may lead to shortfalls in Client Assets.
  - Agency Regimes tend to encourage the bulk transfer of Client Assets. Such Regimes have statutory and regulatory frameworks that support such transfer.
  - Additionally, Agency Regimes permit the preferential distribution of Client Assets from an insolvent Investment Firm. They tend to provide Administrative Officers with specific guidance regarding such distribution.
  - If there is a shortfall, Agency Regimes tend to distribute available Client Assets on a *pro rata* basis. Certain Agency Regimes then permit customers to claim a limited amount of the shortfall against a compensation scheme. Any shortfall that the compensation scheme does not cover becomes an unsecured obligation of the insolvent Investment Firm.
  - Agency Regimes include Canada and the United States (with respect to both the commodity futures and the securities markets).

### C. The Importance of Expedious Transfer or Distribution

Financial markets are complex and volatile. Clients transacting in such markets, when confronted with the insolvency of their Investment Firm, want to minimize disruptions to their trading strategies and to their control of Client Assets as much as possible. Therefore, some jurisdictions value the expedious transfer or distribution of Client Assets. If such transfer or distribution is delayed, clients may face unanticipated exposures<sup>14</sup> of unpredictable magnitude.<sup>15</sup> Such exposures may lead to the client facing significant liquidity pressure. On the other hand, some jurisdictions value certainty, whilst endeavouring to return money and securities as soon as possible. For example, in the UK an Insolvency Practitioner (IP) acts

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<sup>13</sup> Canada requires segregation of client Securities, but only requires segregation of Client Money in excess of a threshold, which is a multiple of capital. Client Money up to the threshold is not required to be segregated.

<sup>14</sup> For example, a client in the securities markets may not be able to acquire a Security it needs to settle a repo transaction. A client in the derivatives markets may not be able to liquidate an unprofitable Position.

<sup>15</sup> In both the securities and derivatives markets, the magnitude of such exposures would depend on the volatility of the relevant instrument.

with personal responsibility. As a result, the IP needs to be satisfied before the distribution is made that the distribution is accurate.

From a systemic perspective, the expeditious transfer or distribution of Client Assets is important, because such transfer or distribution minimizes the risk that the insolvency of an Investment Firm would result in the insolvency of one or more clients thereof. Also, expeditious transfer or distribution of Client Assets minimizes the liquidity pressures on a client, which is advantageous in an environment where liquidity may be increasingly constrained.

#### **D. The Effect of a Shortfall on Transfer or Distribution**

In general, the existence of a shortfall complicates – and consequently delays – the transfer or distribution of Client Assets. For example, with respect to both the securities and derivatives markets, most Regimes require the Administrative Officer to (i) locate the source of the shortfall, (ii) identify the clients that would share in such shortfall, and (iii) calculate the *pro rata* share of each client in the shortfall. Such Regimes would authorize the Administrative Officer to distribute Client Assets only after the completion of (i), (ii), and (iii). This dynamic may be somewhat altered for regimes with a compensation scheme.

Also, with respect to the derivatives markets, the existence of a shortfall creates specific impediments to the transfer of client Positions. No participating Regime reported that it had the power to force a solvent Investment Firm to accept the transfer of client Positions from an insolvent Investment Firm. Therefore, for such a transfer to occur, a solvent Investment Firm has to agree to accept such transfer. In general, a solvent Investment Firm would most likely accept such transfer if the default risk associated with client Positions were minimal. Specifically, a solvent Investment Firm would consider (i) whether the Client Money and Securities supporting client Positions would be simultaneously transferred, (ii) whether a significant shortfall existed in Client Money and Securities, (iii) whether clients would have the ability to advance other assets to cover such shortfall, and (iv) whether there is any governmental assistance that might be provided to cover such shortfall.

Chapters 3 and 4 of this report further describe the strengths and weaknesses of various approaches that Regimes take in treating Client Assets with respect to, *inter alia*, the goal of avoiding shortfalls in Client Assets.

## Chapter 3 Observations on Pre-Insolvency Protections for Client Assets

Set forth below are certain observations on (i) the approaches by which participating Regimes treat Client Assets prior to the insolvency of an Investment Firm and (ii) positive and negative aspects of such approaches in facilitating efficient transfer or distribution of Client Assets after the insolvency of an Investment Firm.

- **Required Segregation**

- **Client Securities.** The majority of Regimes require an Investment Firm to segregate at least some client Securities (e.g., Fully Paid Securities).
- **Client Money.** In general, Custodial Regimes, especially those Regimes that require an Investment Firm to be a banking entity (or where the majority of such firms are banking entities), do not mandate that an Investment Firm that is a bank segregate Client Money. Rather, Custodial Regimes treat Client Money as a general obligation of an Investment Firm.
- **Positive aspects.** In order for a Regime to effectuate a prompt transfer of Client Assets after an Investment Firm declares insolvency, the Regime must have a framework for facilitating the identification of Client Assets. Segregation of Client Assets provides an effective framework for such identification. Segregation, particularly when coupled with reconciliation, also discourages fraud or misuse of Client Assets.
- **Negative aspects of a failure to segregate**
  - As mentioned above, Custodial Regimes generally do not require a solvent Investment Firm that is a bank to segregate Client Money. Therefore, if an Investment Firm becomes insolvent, a client may be treated like an ordinary depositor, with a claim primarily against the compensation scheme. In that case, a client may not recover all of its Client Money.
  - Treating Client Securities differently than Client Money may lead to unintended consequences. For example, in the derivatives markets, if clients deposit Client Money to support Positions, then it may be challenging for a Regime to promptly transfer client Positions, because (i) Client Money in excess of compensation scheme limits would not be available and (ii) Client Money within such limits would be available on a delayed basis. Clients may choose to deposit Securities to support Positions.

- **Omnibus Account**

- **Client Securities.** Most Regimes permit an Investment Firm to deposit client Securities in an Omnibus Account, although such Regimes require the Investment Firm to maintain books and records that identify the Securities belonging to each client.

- **Client Money.** Most Trust Regimes and Agency Regimes permit an Investment Firm to deposit Client Money in an Omnibus Account, although such Regimes require the Investment Firm to maintain books and records that identify the amount of Client Money belonging to each client. As mentioned above, Custodial Regimes generally do not require that Investment Firms segregate Client Money.
- **Positive aspects.** The use of an Omnibus Account may have certain administrative efficiencies. Also, if there is no shortfall, it may be faster and more efficient to transfer Client Assets in an Omnibus Account than to transfer Client Assets in individual accounts.
- **Negative aspects.** However, depending on the Regime, the use of an Omnibus Account may expose one client to the default risk of another client, particularly when an Investment Firm declares insolvency due to the losses of a specific client. Such losses would likely create a shortfall in Client Assets, which decreases the likelihood of efficient transfer or distribution of Client Assets, as described above. Again, this risk may differ to the extent client losses may be covered by a compensation scheme.
- **Reconciliation.** All Regimes require an Investment Firm to reconcile its books and records to its segregation requirement periodically, although Regimes differ on the frequency of such reconciliation.
  - Approximately half of the Regimes require an Investment Firm (i) to calculate its segregation requirement daily and (ii) to reconcile its books and records with such requirement daily, although such Regimes differ on the deadlines for such calculation and reconciliation (e.g., by noon on the next business day or by the end of the next business day).
  - **Positive aspects.** Frequent calculation of the segregation requirement and frequent reconciliation of books and records with such requirement enables a solvent Investment Firm (i) to detect and resolve shortfalls in Client Assets earlier and (ii) to thereby arrest the accumulation of such shortfalls. The requirement of frequent reconciliation may also serve as a discipline on an Investment Firm, encouraging the continuous application of strong internal controls. Also, as Regimes often require an Investment Firm to report a shortfall in Client Assets, frequent reconciliation may permit a regulator to detect problems with an Investment Firm earlier, including deficiencies in internal controls, fraudulent activity, or financial difficulty.
  - **Negative aspects.** It may be costly to implement frequent calculations of the segregation requirement and frequent reconciliation.
- **Permission/Prohibition of Temporary Deficits and Buffers.** Most Regimes require an Investment Firm to hold exactly the amount of Client Assets specified in the segregation requirement. Such Regimes consider either a deficit or surplus in Client Assets to be a reportable irregularity. Some regimes such as the UK and the US explicitly allow an Investment Firm to hold a surplus in Client Assets, commonly referred to as a buffer, because they view it as prudent to do so in the interest of customer protection.

- As mentioned above, Regimes differ on the frequency with which an Investment Firm must perform reconciliation. In general, the more frequently an Investment Firm performs reconciliation, the more successful it would be at discovering and resolving deficits or surpluses in Client Assets.
- In general, Custodial Regimes and certain Trust Regimes do not permit the Investment Firm to maintain a *buffer* of proprietary assets in an Omnibus Account. As discussed below, Custodial Regimes and certain Trust Regimes tend to emphasize returning to a client the specific Securities due. Inclusion of a *buffer* would attenuate the link between such Securities and the client, and possibly complicate the treatment of client Securities if an Investment Firm becomes insolvent.
- **Positive aspects of prohibiting buffers and temporary deficits**
  - By prohibiting deficits – that is, prohibiting an Investment Firm from holding, even temporarily, less Client Assets than the amount specified in the segregation requirement – a Regime is less likely to encounter a shortfall in Client Assets, which in turn increases the possibility that Client Assets would be promptly transferred or distributed if an Investment Firm becomes insolvent.
  - As mentioned above, Regimes often require an Investment Firm to report a shortfall in Client Assets. Therefore, if a Regime does not permit an Investment Firm to maintain a *buffer*, then the Investment Firm would notify the regulator every time it discovers a shortfall. Such notifications may permit a regulator to detect problems with an Investment Firm, including deficiencies in internal controls, fraudulent activity, or financial difficulty. Thus, the prohibition of a buffer can enhance firm internal controls and prevent the misuse of *error* and similar accounts that played a critical role in the failure of Barings in 1996.
  - In general, under Custodial Regimes and certain Trust Regimes, if the Investment Firm does not maintain a *buffer*, clients may receive client Securities more promptly. Otherwise, an Administrative Officer may freeze the pool of assets until it is able to distinguish between (i) client Securities (which would be distributed to clients) and (ii) the *buffer* (which would be distributed to the general creditors).
- **Positive aspects of permitting buffers or temporary deficits.**
  - If an Investment Firm is not permitted to maintain either a temporary deficit or a *buffer* in Client Assets, then the Investment Firm must perform frequent, precise reconciliations to ensure that it is complying with the segregation requirement. Such reconciliation may be costly.
  - In many instances, an Investment Firm may discover shortfalls in Client Assets resulting from simple clerical errors. It may be cumbersome for (i) the Investment Firm to notify the regulator and (ii) the regulator to review

the notification. If an Investment Firm is permitted to either maintain a temporary deficiency or a *buffer*, then it could avoid making such notifications, as such clerical errors would not result in a shortfall. (To be sure, an alternative viewpoint is that such “simple clerical errors” represent control weaknesses).

- Under certain Agency Regimes and certain Trust Regimes, permitting an Investment Firm to maintain a *buffer* may not complicate the treatment of Client Assets if an Investment Firm becomes insolvent. Such a *buffer* may decrease the likelihood that an Investment Firm would have a shortfall in Client Assets (as client losses guaranteed by the Investment Firm convert the *buffer* to required assets), and would increase the possibility that Client Assets would be promptly transferred or distributed if an Investment Firm becomes insolvent.
- **Treatment of Debit Balances.** With respect to Client Assets held in Omnibus Accounts, most Regimes prohibit an Investment Firm from offsetting credit and debit balances across different clients.
  - **Benefits of prohibiting the use of debit balances to offset credit balances.** An Investment Firm is prohibited from using the Client Assets of one client to finance the transactions of another client, thereby decreasing the risk that the latter poses to the former in an Omnibus Account. Such prohibition decreases the likelihood that an Investment Firm would have a shortfall in Client Assets, and increases the possibility that Client Assets would be promptly transferred or distributed if an Investment Firm becomes insolvent.
  - **Benefits of permitting debit balances to offset credit balances.** Offsetting credit and debit balances across different clients may have administrative and capital efficiencies, depending on available financing transactions in a Regime.
- **Fungibility**
  - **Across Asset Classes.** Most Regimes prohibit an Investment Firm from treating Client Money and client Securities as fungible for purposes of Client Asset protection. In general, if an Investment Firm becomes insolvent, such Regimes may accord less protection to Client Money than client Securities.
    - For example, as mentioned above, Custodial Regimes generally do not require Investment Firms to segregate Client Money. Also, under the Trust Regimes, if an Investment Firm becomes insolvent and transfer proves impracticable, Client Money that the Investment Firm improperly excluded from segregation (whether due to fraud or negligence) may not qualify for preferential distribution.
  - **Within Asset Classes.** Most Regimes prohibit an Investment Firm from treating one client Security as fungible with another client Security unless both Securities have the same terms and conditions, i.e., the same CUSIP or ISIN.

- In some cases, clients owning different securities may be treated differently. For example, under Custodial Regimes and Trust Regimes, if an Investment Firm becomes insolvent, transfer proves impracticable, and there is no shortfall with respect to client Securities with one CUSIP or ISIN whereas there is a large shortfall of client Securities with a different CUSIP or ISIN, then clients due the former would be satisfied in full while clients due the latter might receive a *pro rata* distribution and limited remuneration from the compensation scheme.
  - With respect to securities, one alternative to Transfer is *distribution in kind*, which may be favored if Securities of the right CUSIP or ISIN are available to be distributed (whether from within the existing Client Assets, or available for purchase at a price that does not exceed the available value to be distributed).
  - If an Investment Firm becomes insolvent and both transfer and distribution in kind prove impracticable, then client Securities would be liquidated. The proceeds from such liquidation may be aggregated with Client Money, and such aggregated amount may be distributed to clients on a *pro rata* basis.
  - *Positive aspects of prohibiting the treatment of different securities as fungible.* The prohibition against fungibility increases the likelihood that a client would recover its specific Securities from the insolvent Investment Firm. The Custodial Regimes and the Trust Regimes may place a higher premium on such recovery in kind than certain Agency Regimes. Distribution of Client Assets in kind may also avoid certain potential taxation issues that might arise from what might be deemed to be sales of such assets.

- **Right of Use**

- Agency Regimes prohibit an Investment Firm from using client Securities in certain ways, regardless of client consent.
- In contrast, most Custodial Regimes and Trust Regimes permit an Investment Firm to encumber, rehypothecate, or otherwise use client securities with written client consent (sometimes for all clients, in other cases only for non-retail clients). Depending upon the Regime, the re-hypothecation or other use may result in the amount of Customer Assets in segregation being less than the amount owed to customers.
- **Positive aspects of prohibiting right of use.** The prohibition against Investment Firm use of Client securities diminishes the likelihood of a shortfall in Client securities, which increases the possibility that such securities will be promptly transferred or distributed if an Investment Firm becomes insolvent. For example, an Administrative Officer could easily locate and liquidate such client securities, and distribute the proceeds from such liquidation on a *pro rata* basis to clients, along with Client Money. Moreover, the prohibition against re-hypothecation eliminates the necessity of accounting for the securities of clients who have granted such rights of use. Without such a prohibition, a complicated process of accounting for distributions to clients will be necessary, including for those clients

who have not granted such rights of use. Consequently, clients may face waiting periods of months, perhaps years, to obtain return of securities.

- **Positive aspects of permitting right of use.** Custodial and Trust Regimes generally give more effect to personal choice in this context. Moreover, they may permit clients to enter into market transactions at lower cost (i.e., because they essentially allow greater leverage), and this may lead to greater market liquidity. For example, a client may choose to permit an Investment Firm to encumber, re-hypothecate, or otherwise use securities in exchange for lower margin or other transaction fees.
- **Holding Client Assets at third-party affiliates.** Most Regimes permit an Investment Firm to hold Client Assets at third-party affiliates.
  - **Positive aspects.** Permitting an Investment Firm to hold Client Assets at third-party affiliates may have certain administrative efficiencies, the benefits of which may be shared with clients.
  - **Negative aspects.** As the 1996 Report notes, “[w]hile there is a widespread commercial practice by investment firms of using related parties for the safekeeping of client assets, the risk to clients through intra-group contagion can be increased.”<sup>16</sup>
    - Experience with Lehman (and, earlier, with Enron) suggests that, if an Investment Firm within a corporate group becomes insolvent, it poses a contagion risk to its affiliates such that, due to a loss of confidence by counterparties or lenders, the affiliates are highly likely to become insolvent at the same time or shortly thereafter, posing significant complications with distribution or transfer. This experience is in contrast to cases where Client Assets are lodged with an independent, third-party custodian, which is far less likely to suffer an insolvency contemporaneously with the depositing firm.
    - More generally, there are concerns that an Investment Firm, due to inherent conflicts of interest, may not be able to use the same degree of due diligence when selecting an affiliated third party as custodian as it would when selecting an unaffiliated third party as custodian.
- **Waiver of Client Asset protections.** Most Regimes do not permit clients of an Investment Firm, regardless of their level of financial sophistication, to, in such terms, waive protections of Client Assets. However, as noted above, most Custodial Regimes and Trust Regimes permit an Investment Firm to encumber, rehypothecate, or otherwise use client Securities with written client consent. If an Investment Firm becomes insolvent, then the Regimes may not extend certain Client Asset protections to such Securities.

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<sup>16</sup> Ibid. at p. 20.

- **Positive aspects of permitting waivers.** As the 1996 Report observes, “[i]f an investment firm is not required to provide asset protection to professional clients, it can reduce its operational costs accordingly. As long as such cost reductions are reflected in reduced costs for investors, there can be a benefit as well as a cost attached to a lack of client protection.”<sup>17</sup>
- **Negative aspects of permitting waivers.** As the 1996 Report states, “[i]f client asset protection is deemed to be an important factor in overall market confidence and integrity and in facilitating the transition of funds from and the isolation of risk to a failing firm, some might argue that such protection should apply regardless of the status of the client.”<sup>18</sup>

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<sup>17</sup> Ibid. at p. 24.

<sup>18</sup> Ibid.

## Chapter 4 Observations on Post-Insolvency Treatment of Client Assets

Set forth below are certain observations on the manner in which participating Regimes treat Client Assets after the insolvency of an Investment Firm.

- **Regulator Control over Insolvency.** Regulators have different degrees of control over the insolvency of an Investment Firm. In certain Regimes, regulators are responsible for (i) placing an Investment Firm into insolvency, (ii) appointing an Administrative Officer, and (iii) supervising such Administrative Officer. In other Regimes, regulators play a less direct role in the insolvency of an Investment Firm (e.g., they may coordinate with, but not supervise, the Administrative Officer). In still other Regimes, regulators play no role in the insolvency of an Investment Firm.
- **The Administrative Officer**
  - **Expertise.** Certain Regimes require that an Administrative Officer for an Investment Firm have prior expertise in handling the insolvency of an Investment Firm. Other Regimes only require that an Administrative Officer meet certain character and creditworthiness qualifications.
  - **Guidance.** Certain Regimes provide detailed statutory, regulatory, and practical guidance on the manner in which the Administrative Officer must handle the insolvency of an Investment Firm. Other Regimes do not provide guidance specific to the insolvency of an Investment Firm.
  - **Liability.** Under certain Regimes, an Administrative Officer has full personal liability for any losses to creditors resulting from any violations of the Regime. Under other Regimes, an Administrative Officer is liable only for gross negligence or willful misconduct.
  - **Discussion**
    - In order to (i) better protect clients of Investment Firms and (ii) maintain the integrity and efficiency of the financial markets, a Regime may wish to ensure that the Administrative Officer has prior expertise in the insolvency of an Investment Firm and can access appropriate guidance regarding such insolvency. Such an Administrative Officer would be more likely to prioritize the expeditious transfer or distribution of Client Assets, and would be better equipped to effectuate such transfer or distribution.
    - If a Regime wishes to facilitate expeditious transfer or distribution of Client Assets, then such Regime may wish to consider subjecting the Administrative Officer to a less strict standard of liability, so the Administrative Officer would have less incentive to freeze accounts containing Client Assets until the Administrative Officer could verify beyond question that such transfer or distribution is completely correct (e.g., that no proprietary assets have been commingled in such accounts).

- **Transfer**

- In general, the expeditious transfer of Client Assets from an insolvent Investment Firm to a solvent Investment Firm minimizes financial disruption to clients and enhances systemic stability.<sup>19</sup>

- As mentioned above:

- Most Trust Regimes do not have an overarching arrangement to facilitate the transfer of Client Assets. However, such Regimes will permit and encourage such transfer on a case-by-case basis, with client consent.

- Most Custodial Regimes do not have an overarching arrangement to facilitate the transfer of Client Assets. Certain Custodial Regimes do not permit such transfer.

- Agency Regimes encourage the bulk transfer of Client Assets, favoring speed, rather than conducting a customer-by-customer calculation. Such Regimes have statutory and regulatory frameworks that support such transfer.

- **Discussion**

- A case-by-case transfer of Client Assets with client consent has the advantage of maximizing personal choice. For example, one client may choose to transfer its Client Assets to one Investment Firm, whereas another client may choose to transfer its Client Assets to another Investment Firm.

- However, in a situation where the financial status of an Investment Firm is deteriorating rapidly, a case-by-case transfer of Client Assets with client consent may not be feasible. In such a situation, a bulk transfer may be necessary. Moreover, clients of an insolvent Investment Firm may benefit from having their Client Assets transferred to a solvent Investment Firm with which they might otherwise not choose to do business, with a later opportunity to onward transfer to another Investment Firm of the client's individual choice.

- A bulk transfer is also advantageous in a situation where an Investment Firm holds certain Client Assets and deposits other Client Assets with a clearing organization for derivatives, which collects Client Assets on a net basis.

- **Avoidance of Preferential Transfers or Distributions.** Most Regimes do not permit the Administrative Officer to avoid preferential transfers or distributions of Client Assets occurring prior to the insolvency of the Investment Firm.

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<sup>19</sup> Of course, the expeditious distribution of Client Assets from an insolvent Investment Firm also minimizes financial disruption to clients and enhances systemic stability. However, this Chapter of the report focuses on transfer because SC3 included a specific question on transfer in the Survey.

- For example, in Trust Regimes and Custodial Regimes, the Administrative Officer has no legal basis for such avoidance, as clients retain unambiguous ownership of segregated Client Assets.
- **Discussion**
  - Legal certainty on the irrevocable nature of such transfers enhances systemic stability.
  - However, if there is a shortfall in Client Assets, permitting clients to keep Client Assets, in excess of their appropriate share of such assets, that were transferred or distributed prior to the insolvency of the Investment Firm may be inequitable to clients that did not receive similar transfers or distributions. Specifically, the latter clients would bear a greater share in the shortfall due to circumstances not within their control.
- **Compensation Scheme.** Most Regimes have a scheme to compensate clients for losses resulting from the insolvency of the Investment Firm.
  - **Discussion**
    - Such schemes often exclude institutional investors or, where institutional investors are included, provide compensation in amounts that would only be significant to retail investors. As set forth in Row 21 of the chart in Appendix A, maximum amounts of compensation ranged from approximately US\$15,000 to US\$1,000,000.
    - Therefore, such schemes should be seen as complementary to, but not a substitution for, strict segregation requirements.
- **Loss Allocation.** In general, if there is a shortfall in Client Assets, Regimes tend to distribute such Client Assets on a *pro rata* basis.
  - As mentioned above, Trust Regimes and Custodial Regimes tend to divide Client Assets into (i) different asset classes and (ii) different instruments within one asset class. Such Regimes would then distribute Client Assets on a *pro rata* basis only to (i) clients who made contributions to such asset class or (ii) clients who deposited a specific type of instrument.
    - For example, if Client A contributed cash, whereas Clients B and Client C contributed a certain type of Securities, then (i) Client A will not share in a distribution of such Securities, and (ii) Clients B and C will share *pro rata* in such distribution.
  - **Discussion**
    - As mentioned above, such loss allocation increases the likelihood that a client would receive far less than its claim, when large shortfalls exist in

specific asset classes or between different instruments in one asset class, due to reasons not within client control.

## **Chapter 5      Conclusion**

This report, both in the taxonomy and analysis presented above, and in the summaries and detailed responses to questions presented in Appendices A and B, should enhance transparency and the ability of regulators and market participants to understand the methods (and positive and negative aspects of such methods) by which the responding Regimes protect Client Assets, both before and after the insolvency of an Investment Firm.

## Glossary

(1) “**Administrative Officer**” refers to the person or entity who is appointed, whether by a court, regulator, creditors, the Investment Firm itself, or otherwise, to assume control of or power over a bankrupt or insolvent Investment Firm. This term includes administrators, debtors in possession, receivers, liquidators, trustees, and similar titles.

(2) “**Client Assets**” refers collectively to Positions, Securities, and Client Money:

- “**Positions**” are contractual rights and obligations arising from transactions entered into by an investment firm on behalf of its clients, including mark to market accruals arising from the change in value of futures, options and/or other derivatives positions;

- “**Securities**” are defined to incorporate securities as that term is defined or understood in each responding jurisdiction; and

- “**Client Money**” refers to funds owed to or held on behalf of clients by an investment firm, and may include margin collateral associated with client positions (both existing and potential), income relating to an investment such as dividends or interest, proceeds of the liquidation of client securities and/or positions, and funds in excess of required margin.

(3) “**Investment Firm**” means an intermediary that holds Client Assets and is engaged in the business of managing client accounts, which could include, without limitation: executing orders on behalf of others, dealing in or distributing Securities (including carrying derivatives positions). In jurisdictions where banks are broadly permitted to engage in such a business, this term includes banks to the extent they are providing such services.

(4) “**Omnibus Account**” means an Investment Firm’s account with a third party in which Client Assets are maintained separate from the firm’s assets, but are held in the aggregate instead of in accounts designated for individual clients.

(5) “**Regime**” refers to statutes, regulations, rules of exchanges, clearing organizations and other self-regulatory bodies, or other legally binding requirements.