11 October 2013

The Client Assets Policy & Risk Team
Client Assets Unit – Markets Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London
E14 5HS

By email: fca-cp13-05@fca.org.uk

Dear Sirs,

Re: BVCA Regulatory Committee response to the Financial Conduct Authority consultation paper (CP 13/5) on 'Review of the client assets regime for investment business'

This response to the consultation by the Financial Conduct Authority (the "**FCA**") on its '*Review of the client assets regime for investment business*' (the "**Consultation Paper**") is made by the Regulatory Committee of the British Private Equity and Venture Capital Association (the "**BVCA**").

The BVCA is the industry body for the UK private equity and venture capital ("**PE/VC**") industry. With a membership of over 500 firms, the BVCA represents the vast majority of all UK-based PE/VC firms and their advisers. Its members have invested £33 billion in over 4,500 UK companies over the last five years. Companies backed by UK-based PE/VC firms employ over half a million people and 90 per. cent of UK investments in 2012 were directed at small and medium-sized businesses. As a result when our members hold custody assets the securities held are generally unquoted and unmarketable (because they are in private companies whose articles of association will contain restrictions on transfer) and the circumstances in which they are held are fundamentally different, i.e. the member firm will have control or a significant stake in the private company (and therefore be aware of any activities in relation to the issued capital). The risks and issues which arise are therefore not the same as for a firm which is holding easily transferable securities. One of our concerns is that provisions which may be appropriate for firms which hold marketable securities are unnecessarily burdensome when applied to venture capital/private equity firms.

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We have structured our response so that our general observations on the proposed changes in the Consultation Paper precede our answers to the specific questions. In order to focus our response appropriately, we have not responded to every question in the Consultation Paper, but instead have set out answers to those questions which we believe raise issues which are particularly relevant to PE/VC firms.

We would be happy to discuss any of the issues raised in our responses to the Consultation Paper in further detail with the FCA if this would be of assistance.

Yours sincerely,

Margaret Chamberlain

Margaret Chamberlain
Chair - BVCA Regulatory Committee

FCA CONSULTATION PAPER CP 13/5 ON THE REVIEW OF THE CLIENT ASSETS REGIME FOR INVESTMENT BUSINESS

PART A: GENERAL COMMENTS AND CONCERNS

1. We would like to begin by expressing our general concern about the FCA's approach to the revision of the current client assets regime in CASS. Although many of the proposed changes may, in isolation, be viewed as relatively minor amendments to the existing regime, the cumulative effect of these changes is likely to represent a fundamental shift in the obligations to which firms are subject.

2. We understand the importance of ensuring that client assets and money are adequately protected in the event of a firm's failure. Our concern, however, is that the proposed amendments to the rules in CASS appear to be contemplating the introduction of an inflexible regime which would greatly increase firms' compliance obligations and would punish even minor, inadvertent infractions of the rules which have no substantive effect on the security of client assets. As a result, many of the proposed changes fail to take into account the practical difficulties associated with them and the operational complexity which will result (which itself brings risks).

3. In our responses to the specific questions in the Consultation Paper, we provide examples of certain proposed amendments to the existing rules which we think may prove to be impracticable on a day-to-day basis or which otherwise seem to lack a clear justification. As a general observation, we would encourage the FCA to consider carefully the consequences of introducing requirements for firms to perform certain acts '*immediately*', or within very tightly defined timescales. While these requirements may seem appropriate to the FCA when considered in the abstract, their implementation in the real world may be disproportionately costly or simply unachievable.

4. We strongly doubt that the best interests of clients are served by instituting unworkable regulatory requirements which are unlikely to lead to genuine practical improvements in the level of client asset protection. In our view, the FCA must aim to strike a proportionate balance between client asset protection on the one hand and the ability of firms to provide cost-effective services to their clients on the other. In their present form, we are concerned that the proposed rules have failed to strike this balance in an appropriate manner and are, in any case, unlikely to lead to the realisation of the FCA's desired policy objectives.

PART B: RESPONSES TO CONSULTATION QUESTIONS

Question 17: Do you agree with these proposals on money ceasing to be client money? If not, please provide reasons.

5. We would question the inclusion of the requirement in the revised CASS 7.2.15R(3) that a client must consent to the payment of money into a bank account in the client's own name in order for that money to cease being client money. We note that paragraph 4.40 of the Consultation Paper refers to the fact that *'issues have also arisen'* with transfers of client money into client bank accounts, but without further detail we are unable to see the rationale behind this proposed revision. Indeed, in the context of the policy objective of the protection of client money, we consider that any rules which would add restrictions or complexity to the process of returning client money to a client's own bank account must surely be undesirable.

6. If there is a compelling reason to include this requirement, we would propose that clients should be able to provide their general standing consent to future transfers to their bank accounts, rather than requiring a client to consent to each proposed transfer, as we can consider that the latter requirement may be unduly onerous and unworkable in practice. In this regard, we are concerned that the use of the phrase *'with the specific consent of the client'* in the revised CASS 7.2.15R(3) could be taken to imply that general consent to future transfers would be insufficient to ensure compliance with this rule. Accordingly, if the requirement for consent is to be maintained, we would suggest that the FCA delete the word *'specific'* and include additional wording permitting standing consent to such transfers to be obtained.

7. In addition, we would also propose that the requirement for consent to such transfers could be disapplied for professional clients and eligible counterparties, or that such clients could opt-out of the requirement entirely when the client relationship is established. We consider that these categories of client have the experience and expertise to make a reasoned assessment of whether there would be any compelling reason for them to need to consent to each transfer into their own bank accounts.

Question 23: Do you agree with our proposal to clarify the existing requirements around the immediate segregation of client money? If not, please provide reasons.

8. We have a number of concerns in relation to the proposed requirements for immediate segregation of client money in the revised CASS 7.4. In particular, we note that the proposed rules as currently drafted do not appear to make allowances for the fact that

clients and third parties may transfer client money to a firm's bank account without giving prior notice to the firm. Under the existing regime, although the requirement for prompt segregation already imposes a tight timescale in which money received in such circumstances should be transferred into a client bank account (i.e. no later than the next business day after receipt under the existing CASS 7.4.17G), a firm does have a short period in which to arrange for the transfer of that money in order to ensure that it remains in compliance with the client money rules.

9. The proposed amendments to the rules would mean that where a client or third party transfers money to a firm's account in error, the firm would immediately be in breach of the new CASS 7.4.1AR. Since firms will not always receive prior notice from a client or third party of an impending transfer (which might, if given in time, allow them to advise that party to direct the transfer to the relevant client account), it is unrealistic to expect that firms can arrange for transfers and payments to be made into the client account in every situation. The consequences of a breach of the client money requirements in CASS, even if slight, may be significant in the context of firms which are required to submit a client assets auditor's report to the FCA certifying compliance with the client money rules.

10. In our opinion, the FCA should maintain the current rules which require prompt segregation of client money into a client bank account. This is already a stringent requirement and there is limited risk to clients given that such a transfer must occur by the end of the next business day following receipt of the client money. Any more onerous requirement than exists at present risks creating an unworkable regime for firms.

11. While it may be true, as stated in paragraph 4.69 of the Consultation Paper, that there is a potential risk that a firm might not identify a relevant remittance to the firm's account as client money, resulting in delays in segregation, it is not clear that that risk would be successfully mitigated by the proposed new rules. In the case of transfers of client money to a firm's account made by clients and third parties without a firm's prior knowledge, that risk would remain under the new rules, but would now unjustifiably place the firm in immediate breach of its regulatory obligations as well.

Question 25: Do you agree with our proposal in relation to physical receipts and the allocation of client money? If not, please provide reasons.

12. We consider that the requirement for client money to be allocated to an individual client within five business days following its receipt is unduly onerous and impractical. It is important to recognise that such money will, even before it has been allocated to individual clients, have been paid into the client account and therefore will be subject to

protection on the failure of the firm. Allocating an aggregated client money payment to individual clients may be a complex process and it is important that this is done accurately and within a realistic timeframe. Taking the FCA's example from paragraph 4.75 of the Consultation Paper, it may take a significant length of time to allocate on an individual basis a tax refund paid by HMRC covering a large number of clients who have invested in a range of products. In light of the extensive compliance obligations to which firms are already subject, an expectation that this process will be completed in every case within five business days is unlikely to be practicable in all circumstances.

Question 28: Do you agree with our proposal to clarify the requirements around how a firm should treat client money transferred to a third party? If not, please provide reasons.

13. We are concerned the proposed revisions to CASS 7.5 will, instead of clarifying the rules on client money transferred to third parties, introduce uncertainty into the existing regime. The existing rules recognise that a firm may need to transfer client money to a third party in order to facilitate investment business and, in so doing, that a firm may retain a fiduciary responsibility in respect of that client money.

14. However, the revised wording appears far too wide and vague to be capable of clear and sensible application. The reference to *'allowing another person to hold client money'* in this context seems inconsistent with the definition of client money as money that a firm receives or holds on behalf a client; in a situation where money is transferred directly by a client to a third party, the firm will at no point have *'received'* or *'held'* that money.

15. More generally, the use of the term *'allowing'* has the potential to expand a firm's responsibility considerably; it is one thing to state that firm has responsibility for client money which it has transferred to a third party to facilitate investment business, but quite another to state that a firm automatically has responsibility for amounts transferred to the third party by the client itself. Indeed, it is difficult to see how a firm could prevent a client from transferring money in such circumstances; the idea of a firm *'allowing'* this to occur appears misplaced and is liable to cause confusion about a firm's regulatory duties. It also significantly increases the financial risks to the firm itself. If there is concern over arrangements where amounts are transferred directly by clients, we would propose that this rule should be limited to situations where a firm specifically instructs a client to transfer money to third parties, being money which would otherwise be transferred to the firm.

Question 31: Do you agree with our proposal for the exchange of acknowledgement letters? If not, please provide reasons.

16. While we recognise that there may be merit in requiring the use of a standard template for acknowledgement letters in the future, we would question the proposed requirement for firms to repaper their existing notification and acknowledgement letters where these are in compliance with the current rules. This would be a burdensome and expensive exercise and would not result in an increased level of protection for clients of those firms who satisfy the existing requirements in this regard. We would propose that firms should instead be required to review their existing acknowledgement letters in light of the standard template and where they can reasonably be satisfied that their existing arrangements provide an equivalent level of protection, no repapering should be required.

Question 33: Do you agree with the proposal of clarifying the requirements around the DvP window? Is not, please provide reasons.

17. We do not share the FCA's conclusion in paragraph 5.4 of the Consultation Paper that '*the loss or destruction of share certificates could harm the client in certain circumstances*' where the relevant shares are registered, rather than bearer, instruments and ownership rights are therefore reflected conclusively in a company's register of members. We particularly doubt whether this analysis is correct in the context of PE/VC investments where those share certificates may reflect significant or even majority ownership of private companies by funds which are managed by the FCA authorised firm. We are unable to identify realistic specific risks which would result to clients if such share certificates were lost or destroyed.

Question 35: Do you agree with our proposal to limit the circumstances where a firm may register or record legal title to its own applicable assets in the same name as that in which legal title to client safe custody assets are registered or recorded? If not, please provide reasons.

18. It is not clear whether the proposed changes to the rules on registering safe custody assets in the same name as the firm's assets are intended to have prospective effect only, or whether they will require firms to revise their existing arrangements. If the revised requirements are intended to apply in respect of existing arrangements, we consider that requiring the re-registration of assets in this context will involve unnecessary expense and will add to the compliance burden on firms, with limited benefit. We would therefore propose that if this requirement is to be adopted, it should be limited to future arrangements only.

Question 36: Do you agree with our proposals for requiring written custody agreements and clarification on the terms and details which ought to be included? If not, please provide reasons.

19. Again, it is not clear whether this proposal is to have prospective effect only, or whether it will impose obligations on firms in respect of their existing custody arrangements. We note that while the proposed wording in the new CASS 6.3.4G is labelled as guidance, it states that the examples listed in that provision '*should be addressed*' in written custody agreements and therefore may carry the implication that such terms are mandatory.

20. If this is the case and firms are to be required to repaper existing custody arrangements, this may create complications if, for any reason, any of the issues listed in CASS 6.3.4G have not been covered in existing agreements and the relevant custodians are inflexible about agreeing to revised terms. We therefore assume that the terms listed in CASS 6.3.4G are not intended to be mandatory and that provided that a firm is satisfied that its existing custody arrangements would meet the minimum standards in CASS 6.3.4B (if indeed this is to apply to existing arrangements) and its other obligations under CASS 6, the firm would not be required to appoint new custodians, which could otherwise involve considerable expense.

Question 41: Do you agree with our proposals for frequencies of custody reconciliations and those relating to the handling of discrepancies? If not, please provide reasons.

21. We are concerned about the revised rules in CASS 6.5 which appear to require multiple reconciliations to be performed no less than once every 25 business days. Under the existing guidance in CASS 6.5.4G(2), a firm is required to perform internal reconciliations '*as often as is necessary*', which in our view reflects the sensible position that different types of firms may need to verify the accuracy of their custody records with different levels of frequency, depending upon their particular activities. Similarly, under the existing guidance in CASS 6.5.8G, a firm is required to perform an external reconciliation '*as regularly as is necessary*'.

22. Under the proposed new rules, a firm would be required to perform such reconciliations no less than once every 25 business days, except where a firm only holds physical safe custody assets. In our view, the new rules have been drafted on a "one size fits all" basis and impose disproportionate reconciliation obligations on PE/VC firms whose risk profile and activities are clearly different from other types of asset managers. Since PE/VC firms are likely to engage in transactions less frequently than many other types of investment

firms and typically will be dealing with a narrower range of financial instruments (i.e. predominantly shares) for fewer clients (i.e. the relevant funds), we question the rationale behind requiring more frequent reconciliations in the context of PE/VC firms.

23. This might be contrasted with the position of a discretionary investment manager managing individual portfolios for a larger number of clients who may be entering into trades on a daily basis – in this latter scenario, there is clearly increased scope for possible record-keeping errors which might justify more frequent reconciliation requirements. In its current form, this proposal therefore seems likely to lead to a high level of unnecessary duplication and corresponding increased compliance costs for PE/VC firms. It may then become necessary for such firms to pass such costs on to the ultimate investors, who would not benefit from any increased practical protection as a result.

24. Although the new CASS 6.5.8BR states that a firm '*must consider the frequency, number and value of transactions which the firm undertakes in respect of safe custody assets*' when determining the frequency of its internal and external reconciliations, the current drafting of the proposed rules means that this can only apply so as to require reconciliations more frequently than the 25 business day basic requirement. We consider that if the specific requirement for internal and external reconciliations every 25 business days (rather than as often as is necessary) is to be maintained, there should either be an express carve-out from the requirement for PE/VC firms and other firms which engage in transactions on a less frequent basis, or CASS 6.5.8BR should be reworded so as to allow less frequent reconciliations where justified by the frequency and number of transactions undertaken by the relevant firm.

25. We are also concerned about the proposed revisions to the existing CASS 6.5.10R and the guidance in CASS 6.5.12G. The use of the term '*immediately*' in the new CASS 6.5.10BR in relation to a firm's obligation to make good the shortfall resulting from a reconciliation imposes an unrealistic standard, particularly in light of the possible complexities involved in the reconciliation process. While we appreciate that checks and reconciliations are an important part of the protection of client assets, it is important that the regime is applied in a sensible and proportionate manner and we therefore consider that the existing requirement for a firm to correct any discrepancies '*promptly*', which is already an appropriately high standard, should be retained.

26. We do not understand why the FCA has deleted the provisions in the current CASS 6.5.10R and 6.5.12G which specify that a firm is only required to make good any unreconciled shortfall for which there are reasonable grounds for concluding that the firm is responsible. We are concerned that in the absence of such provisions, the revised

wording in CASS 6.5.12G requiring a firm to *'resolve the position promptly'* could be read as requiring a firm to make good the shortfall itself pending resolution of the position, which would be an unfair burden on firms which are not to blame for the shortfall. We do not consider that the objective of the protection of client assets can justifiably impose what could in effect become strict liability on a firm for the failures of third parties.

27. We note that the existing wording of CASS 6.5.12G already states that a firm may only conclude that another person is responsible for a shortfall *'where justified'* and therefore this precludes a firm which does not have reasonable grounds for asserting that it is not to blame from relying on that guidance. Accordingly, we are opposed to the deletion of the existing wording in CASS 6.5.10R and CASS 6.5.12G, which we think reflects the logical and justifiable position that a firm which is not at fault should not be required to make good the shortfall, but should nonetheless take steps to resolve the situation with the third party which is responsible.

Question 45: Do you agree with our proposals around the information that firms should be required to provide to clients about their holdings of client assets? If not, please provide reasons.

28. We do not consider that it is appropriate to remove the distinction between different types of clients in COBS 6.1.7R. Certain categories of information which at present need only be provided to retail clients do not seem appropriate for professional clients or eligible counterparties – for example, we doubt whether it is necessary to explain in detail the level of risk to be reflected in a manager's exercise of investment discretion to such clients, given their level of expertise and/or experience. In our experience, the provision of much of this information would impose an additional compliance burden on firms without a corresponding benefit to sophisticated clients who will ordinarily perform their own analyses of investment and insolvency risk is such situations prior to investing. Given the variation in levels of experience and background knowledge between retail and professional clients, we doubt that one single standard of disclosure would achieve the desired policy objective.

Question 46: Do you agree with our proposals for the introduction of a Client Assets Disclosure Document? If not, please provide reasons.

29. We are concerned by the proposed introduction of a requirement for a Client Assets Disclosure Document ("**CADD**") which would *'include a statement of the likely consequences of these arrangements for the treatment of a client's custody assets and client money'* and would include *'how client assets may be treated on the failure of the*

investment firm'. We consider that producing the CADD, which the FCA would require to be provided both before the provision of services and on at least an annual basis thereafter, would be an extremely onerous task, especially considering the complexity of insolvency law and practice.

30. We note, for example, that the FCA itself acknowledges in the Consultation Paper that the legal rules which apply on the insolvency of a firm are complicated and that it has taken recent case law in the form of the protracted Lehman Brothers litigation to clarify a number of points in respect of the existing client asset rules. We therefore doubt that it is appropriate to expect firms to produce CADDs on a regular basis which explain the insolvency situation and we note that this would also add considerably to firms' compliance costs by necessitating extensive legal advice. The requirement to update the CADD whenever the terms of an underlying client agreement are amended so that the CADD no longer accurately records the agreement's provisions would be particularly onerous.

31. We also doubt the utility of such a disclosure document where, as might be expected in many cases, it would be necessary to include caveats as to the treatment of arrangements on insolvency. Even without caveats, given the complicated nature of the law in this area, we doubt that clients would gain any benefit from such a document unless they themselves obtained professional advice interpreting its contents. Accordingly, we believe that the CADD is another measure which would add to the regulatory burden already weighing on firms without achieving any significant corresponding regulatory protection for clients.