The FCA Sets Down Custody Marker

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12 May, 2015

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The record fine imposed by the UK's Financial Conduct Authority (FCA) on US bank BNY Mellon's UK entities - BNY Mellon London branch (BNYMLB) and Bank of New York Mellon International Ltd (BNYMIL) - for breaches of the rules on the safekeeping of client assets signals an aggressive new stance by the UK regulator. The FCA's findings could prompt reviews of business models and management processes at other custodians. Meanwhile, investors need to take a close look at the robustness of their existing custody arrangements.

Serial Offenders in Custody

On 14 April 2015, the FCA published a 33-page final notice detailing its findings of failings at BNYMLB and BNYMIL and disclosing that it had fined the firms a joint £180 million, reduced to £126 million under the FCA's rules for agreed early settlement.

BNY Mellon is the world's largest custodian bank, while BNYMLB and BNYMIL are the third- and eighth-largest UK custodians, respectively. Their collective safe custody balances during the period covered by the regulator's investigation (2007-2013) peaked at over £1.5 trillion.

The BNY Mellon fine was nearly four times larger than a penalty imposed on Barclays in September 2014 for custody failings, previously the largest charge of this type made by the UK regulator. It was also the eighteenth penalty levied in four years on UK financial institutions for breaches of the UK's custody rules (or "CASS") regime. The FCA was keen to stress the seriousness of the case and its implications for other custodians.

"Our custody rules are in place to ensure that clients are protected in the event of insolvency. The [BNY Mellon units'] failure to comply with our rules including their failure to adequately record, reconcile and protect safe custody assets was particularly serious given the systemically important nature of the Firms and the fact that safeguarding assets is core to their business," said Georgina Philippou, acting director of enforcement and market oversight at the FCA, commenting on the BNY Mellon fine.

"Client assets protection continues to be a priority for the FCA and firms who hold client assets should review their processes in line with these findings to ensure full compliance with the custody rules," added Georgiou.

Details of the Breaches

As detailed in the FCA's final notice, BNY Mellon's custody rule breaches fell into two principal categories: failure to maintain books and records and to perform reconciliations on an entity-specific, rather than a firm-wide basis; and unauthorised use of clients' assets, held in omnibus accounts, to settle the trades of other clients, as well as a failure to segregate client assets in omnibus accounts from assets belonging to the bank.

Other management lapses at BNY Mellon included the failure to implement CASS-specific government structures, failure to provide CASS-specific training to employees with oversight for custody, and delays in the production of the bank's CASS resolution pack, a requirement introduced in 2012 to help insolvency practitioners "resolve" a failed bank and pay out client assets swiftly.

BNY Mellon has indicated that it had implemented systems and procedures to operate in a fully CASS-compliant way by the end of August 2014, although it should be noted that this only applies to the UK entities and that other global entities of BNY Mellon may not necessarily follow practices similar to those required by the CASS rules.

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The Lehman Legacy

The roots of the FCA's sensitivity to bookkeeping being carried out at an entity-specific, rather than a firm-wide basis lie in the Lehman failure of 2008, which highlighted flaws in the client asset rules of the time. Despite its legal requirement to do so, Lehman's UK entity had failed to segregate client from proprietary assets, leading to a multi-billion dollar shortfall in the UK client asset pool.

Conflicting claims by Lehman's clients set in train a lengthy legal battle, which ended in the UK Supreme Court in 2012. At issue was the question of whether only those clients whose assets had been properly segregated were entitled to claim from the client pool, or whether all clients had a claim, irrespective of whether Lehman had followed correct procedures. The UK Supreme Court took the latter view, even though this overturned long-standing principles of English trust law.

The Supreme Court's judgement meant that, henceforth, even if clients made efforts to ensure that their assets were properly segregated by an investment firm, in the case of the firm's failure the properly segregated clients' claims could be diluted through no fault of their own by the ability of non-segregated clients to access the pool of client funds.

To reduce the risk of this occurring, the UK regulator placed emphasis in post-2012 revisions to the CASS rulebook on the principle of "sub-pooling": in other words, instead of the client money of an investment firm being treated as a single pool in the case of the firm's insolvency, it could be allocated to specific sub-pools, according to client type or business line.

This, in theory, could be expected to result in speedy pay-outs to clients with assets in a specific sub-pool; a marked contrast with the multi-year wait for restitution faced by UK clients of Lehman (and subsequently, of MF Global, a broker/dealer which failed in 2011).

By performing bookkeeping and reconciling accounts at a global, rather than UK entity-specific level, it is this principle that BNY Mellon failed to heed in time in the running of its UK business, the FCA noted.

BNY Mellon says that to meet this new requirement it spent three years, from 2011-2013, reviewing client agreements and tagging those with a relationship with its London branch or UK subsidiary (and therefore covered by the CASS rules) with an appropriate legal entity identifier by client on the bank's custody platform.

Paying Paul from Peter's Pocket

Another FCA finding—BNY Mellon's unauthorised use of certain clients' funds to settle others' trades—relates to an area of significant complexity.

According to the FCA's final notice, on occasions the bank used clients' assets held in omnibus accounts, without the express prior consent of all the clients whose assets were held in those accounts, to settle a transaction before corresponding assets had been received under a covering trade of the relevant client. This resulted in some clients' assets being used without consent to settle other clients' trades. During most of the period from November 2007 to August 2013, the FCA said, the two BNY Mellon entities did not have in place systems and controls that could identify the number of instances of this failure.

The fine notwithstanding, the UK regulator appears to recognise some of the practical difficulties in setting prescriptive rules for settlement delays or errors. In its 2013 consultation paper on the client assets regime, the FCA

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proposed a ban on placing transactions for a particular client until its client money had cleared into a client bank account, arguing that "Peter's money should not be used to pay for Paul's transactions."

But in its 2014 policy statement on the topic, the FCA watered down this proposed restriction, requiring merely that firms should "ensure their organisational arrangements are adequate to minimise the risk that client money held by a firm may be paid for the account of a client whose money is yet to be received by the firm."

What should Investors do?

The repeated fines levied on investment firms for breaches of the client asset rules, including the record penalty recently incurred by BNY Mellon, are testament to the difficulties firms are having in staying in compliance with the changing and complex regulatory regime for asset safety.

Meanwhile, investors are becoming increasingly aware that they can be exposed to a number of safekeeping risks, including the potential inability of custodians to identify invested assets, the potential misuse or commingling of assets held in client accounts, the freezing of assets, poor record-keeping by custodians and the potential loss of cash on the insolvency of a custodian bank.

Further, the increasing globalisation of portfolio exposures exposes investors to different national insolvency regimes. With many investment firms operating via myriad global subsidiaries, large financial firm failures now have a cross-border aspect by default. Meanwhile, the post-crisis rules meant to ensure the stability of financial infrastructures have so far been applied unevenly by region.

Any review of investors' asset safety arrangements should therefore be holistic, and include an evaluation of the strength of global custodians and the indirect risks to which an investor is exposed as a result of that firm's network of sub-custodians, as well as a risk assessment of the local market infrastructures in which assets are held.[1]

[1] Paragraph 7.133 of FCA Policy Statement PS14/9 "Review of the client assets regime for investment business. Feedback to CP 13/5 and final rules" June 2014.

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