October 15, 2013

FSB Secretariat
Financial Stability Board
Sent by email: fsb@financialstabilityboard.org

Re: FSB Consultation Document: Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions

Dear Sirs and Madams,

The Global Financial Markets Association ("GFMA")[1] appreciates the opportunity to comment on the consultation paper issued in August 2013 by the Financial Stability Board ("FSB") entitled "Application of the key attributes of effective resolution regimes to non-bank financial institutions" ("Discussion Paper").

This response seeks to summarise the key concerns and comments raised by GFMA members with respect to Appendix III of the Discussion Paper entitled "Client asset protection in resolution". Specifically, our comments focus on the definition of client assets and on client asset segregation rather than on resolution tools outlined in the Discussion Paper.

The continuing engagement of the FSB with market participants on issues related to the Client Asset Protection is greatly appreciated. We would be pleased to meet with you to further discuss any of the matters referred to in this letter. Please contact Sidika Ulker, Director, Association for Financial Markets in Europe, or Robert Toomey, Managing Director and Associate General Counsel, Securities Industry and Financial Markets Association by email (sidika.ulker@afme.eu; rtoomey@sifma.org) should you require further information.

[1] The Global Financial Markets Association brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit http://www.GFMA.org.

I. Definition of client assets

We agree that rehypothecation should be contemplated in the context of a client asset protection regime but only in relation to record keeping, reporting and disclosure requirements where relevant[2] and not for the purpose of any of the other sections of the Appendix (e.g. transfer powers). At the point in time when a client asset is rehypothecated and the tangible security is no longer a client asset, it ceases to fall within the definition of client assets. We would be grateful if the FSB would clarify and confirm this in the document.

We note that there have already been discussions with, and submissions made to, the FSB with regard to this matter in connection with the FSB's Workstream 5 on Securities Lending and Repos. GFMA broadly agrees with the conclusions in the report published by the FSB under Workstream 5 in August 2013. Further, we note that there have been a number of other regulatory workstreams that have looked at the issue of rehypothecation; we strongly recommend that regulatory proposals on this issue are consolidated, consistent and harmonised.

II. Europe

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

1) cash (where held on a full title transfer basis) and securities;
2) in respect of client securities held at all times in custody, the ***proprietary*** right of a client to the return of such securities - it being understood that because most securities are held on dematerialised basis, clients retain an individual proprietary claim to interests in a pool of fungible securities; and
3) in respect of client securities which have been rehypothecated, the ***contractual*** right of a client to the return of "equivalent securities" of an identical type, nominal value, description, class and amount.

To elaborate, at the point in time when the firm exercises its right to rehypothecate client securities pursuant to the terms of the contract with its client, the firm becomes the legal and beneficial owner of those securities. Simultaneously, the client ceases to have any proprietary interest in the securities; the client will instead have an economic interest, meaning that it will have a contractual claim against the firm for redelivery of equivalent securities. As the firm becomes the proprietary owner of the securities, it can use the securities in that capacity; such use may include transferring title to a third party or granting a security interest over the securities in favour of a third party. On the insolvency of the firm, the client will become an unsecured creditor for the nominal value of the rehypothecated securities subject to any rights of netting or set off.

[2] Please refer to the final paragraph of the section subheaded "United States" of this letter

Further, in both cases, the client may not be entitled to the return of some or all of the securities or equivalent securities as its account may, for instance, be subject to a security interest and/or netting or set off provision which would extinguish such right of return upon a client default. It is important that such contractual (or statutory) arrangements are respected and that the definition of client assets takes into account any arrangements which result in the loss of the client's proprietary or contractual right to return of the securities or equivalent securities. For example, the transfer powers as described in Appendix III would undermine these contractual rights.

In relation to the provision of adequate information to clients, firms currently provide regular and detailed reports to clients. With regard to the specific structure of the reports, many prime brokerage clients prefer to receive an account report which details all assets held at the prime broker (not just rehypothecated assets); this enables the client to view the economic value of its overall portfolio in one report. However, in light of the various legal frameworks and insolvency regimes, firms are not able to provide information to clients on how shortfalls will be addressed.

III. United States

The United States has broker-dealer regulations, which are relevant to broker-dealers but not to other intermediaries such as bank custodians. The U.S. broker-dealer regulations provide protection for the net equity value of customer accounts on an aggregated basis.

In addition, U.S. property and insolvency laws specifically address securities held in book-entry form through tiers of intermediaries (often referred to as dematerialised securities).

Under U.S. property laws, the interest of the account holder in a specific dematerialised security is a "security entitlement", which is a bundle of property and contractual rights vis-à-vis the account holder's direct custodian (for instance, an investor vis-à-vis its brokerage firm or a customer of a bank custodian). The account holder does not have a direct property claim against its custodian's subcustodians, the central securities depository or the issuer.

If the custodian is a U.S. registered broker-dealer, the net equity value of its customers' accounts is protected by requiring the broker-dealer to (i) segregate certain securities; and (ii) maintaining special reserve accounts relating to customer cash.

For cash, the broker-dealer must lock-up the aggregate net cash credit balance of its customers in special reserve accounts maintained at banks for the exclusive benefit of its customers. For securities, fully-paid securities are segregated and cannot be rehypothecated. If a customer borrows cash in the margin account, generally, the broker-dealer may use/rehypothecate securities having a market value of up to 140% of a customer's debit balance and the remaining securities ("excess margin securities") are held in segregation.

The use/rehypothecation of customer securities has no adverse effect on the protection of the net equity in the customer's account because (i) the rules require that assets be added to the special reserve account formula when customer securities are use/rehypothecated; and (ii) there is no distinction in a US broker-dealer bankruptcy between the net equity claim of a customer whose securities have been used/rehypothecated and the net equity claim of a customer whose securities have not be used/rehypothecated.

In case of bankruptcy of the U.S. broker-dealer, net equity claims of customers must be met in full using the segregated securities, special reserve accounts and other assets deemed to be customer property before any other creditors would have access to those assets. In the event there was insufficient customer property to meet the full amount of customers' net equity claims, those claims would be satisfied pro rata and no customer property would be available to other creditors.

If the custodian is not a broker-dealer (e.g. a bank custodian), security entitlements are held in book entry form solely for account holders; under the custody agreements, bank custodians typically do not have a right of rehypothecation or re-use, but may retain security interests over these assets to secure indebtedness of customers.

Since rehypothecation of a customer's securities does not impact a customer's net equity claim in the bankruptcy of a U.S. broker-dealer, requiring the broker-dealer to provide client with reporting of specific securities rehypothecated would impose a significant additional burden on the broker-dealer without any adding any benefit to the customer.

IV. Agency securities lending

We note that the provisions do not make sufficient distinction between whether they relate to prime brokerage or to agency securities lending. We feel that market participants would benefit from further delineating these provisions which solely relate to prime brokerage from those which relate to agency securities lending.

V. Client asset segregation

Regarding asset segregation, the guidance should make clear that actual segregation is not the only method of achieving the goal of protecting against the loss of client assets in the event of the insolvency of the firm. One alternative method would be to require that adequate books and records are kept in a manner that enables the parties to quickly and clearly determine the ownership of the assets. In our view, to meet this outcome, it is not necessary for the firm to maintain segregated accounts for each individual client (e.g. we refer to the current FCA CASS Rules for UK firms).

Finally, we request that the FSB clarifies that jurisdictions should have in place rules that recognise foreign cross border resolution tools and actions, including those regarding asset pool

In closing, we wish to reiterate that the continuing engagement of the FSB with market participants on issues related to client asset protection is greatly appreciated and we welcome the opportunity to comment on the Discussion Paper. We would be happy to answer any further questions you may have.

Kind regards,

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