The law and regulation of custody securities: cutting the Gordian knot

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Key points

- Two separate regimes are recommended for the two different elements of the contemporary custody service, namely traditional custody and client securities finance. This would permit effective, targeted and proportionate regulation without inhibiting market efficiency.
- It would also relieve policy differences currently impeding international law reform initiatives.
- In relation to client securities finance, market solutions for addressing credit exposure should be adopted, particularly close-out netting, in place of the traditional property rights which exposed clients to long delays in the return of their assets in the failure of Lehman Brothers (International) Europe.

Stop press

On 10 June the FCA published its Policy Statement 14/9, giving final rules on custody and client money. Sadly, the approach suggested in this article has not been taken.

1. Overview

Context

In the EU, proposals for the Securities Law Legislation (SLL) has stalled, at least for the present. Internationally, the UNIDROIT Geneva Convention 2009[1] (Geneva Convention) is not yet in force. In the UK, some five and a half years after the failure of Lehman Brothers (International) Europe (LBIE), the FCA's client asset review is ongoing and the Bloxham Review[2] has called for a fundamental reappraisal of the legal basis of client entitlements.[3] Clearly, the law and regulation of custody securities is not an easy nut to crack.

Law and regulation inseparable

It is beyond doubt that securities custody requires both legal and regulatory reforms. The two are inseparable, and the UK regulatory client asset review should be considered together with UNIDROIT and the EU SLL.

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1 UNIDROIT (International Institute for the Unification of Private Law) Convention on Substantive Rules for Intermediated Securities, UNIDROIT, Geneva 9 October 2009.

2 Peter Bloxham, *Final Review of the Investment Bank Special Administration Regulations 2011*, January 2014 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/271040/PU1560_SAR.pdf> accessed 2 June 2014.

3 Recommendation 54: 'Fundamental review of law. Consider need for radical review of law under which client entitlements can arise in UK Client Asset protection regime, and whether appropriate to rely on property, trust and insolvency law concepts, in context of fast moving and intangible rights of modern and sophisticated investment markets.'

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Breaking the log jam

The delivery of such reforms has been hampered (first) by the great complexity of the operational and legal detail, and (secondly and more fundamentally) by a lack of policy consensus on key questions.

This discussion offers a way forward. It identifies the underlying problem as the conflicting needs of two different elements of the custody client base, namely traditional investors and collateral givers. It recommends that the conflict be sidestepped, by creating two distinct regulatory and legal client protection regimes, to apply to different clients, or to different elements of client portfolios, according to the commercial service agreed between client and custodian.

Two custody services

Two classes of client

A 'one-size-fits-all' approach to the law and regulation of custody is no longer fit for purpose, because of the emergence of two differing classes of client.

Traditional long-term investor

At one extreme is the traditional, long-term institutional investor, who buys to hold and is an active shareholder. Its priorities are: maximum asset protection, and maximum corporate entitlements (particularly information and voting rights). The importance of these services justifies to the client their additional costs. These extra costs reflect the operational burden to the custodian. The custodian's ability to facilitate high frequency trading is not important to such a client, who is best served by individual segregation,[4] and the related ability to identify and enforce its interest at the level of the CSD 'look through',[5] and the full delivery by the custodian of corporate entitlements.[6]

Long/short hedge fund

At the other extreme is the long/short hedge fund. Its arbitrage strategy won't work without maximum speed of dealings, and won't be profitable without high leverage and a cost-efficient custody service. It needs to deploy its custody assets as collateral to raise finance, and to do so quickly. This client is best served by pooling[7] (to reduce costs and provide the liquidity necessary for efficient securities borrowing), the choice of law rule known as Place of Relevant InterMediary Account (PRIMA)[8] (to simplifying the legal aspects of portfolio securities finance),[9] Title Transfer Collateral Arrangements

4 With client individual segregation, the custodian does not commingle the like assets of different clients, but holds each clients' securities in a separately designated account maintained by the relevant central securities depositary (CSD) or sub-custodian.

5 These arrangements provide maximum client asset protection.

6 This facilitates activism.

7 With pooling the custodian holds all the like assets of all its pooled clients in a single client omnibus account with the relevant CSD or sub-custodian.

8 PRIMA is a choice of law rule providing (very broadly) that the law applicable to property questions affecting indirectly held securities are governed by the law of the country where the relevant account is maintained. The relevant account for this purpose is that maintained by the intermediary to which the interest of the client is credited.

9 Portfolio finance is the use of a mixed portfolio of securities (eg issued from different jurisdictions) to collateralize finance.

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(TTCA)[10] and/or rehypothecation,[11] (to facilitate the reuse of financial collateral, in the interests of leverage and liquidity) and reliable close-out netting rights[12] (to manage credit exposures in securities finance). Corporate entitlements are less important, and may not merit the costs of delivery.

Middle ground

In the middle is the typical traditional institutional investor under financial pressure,[13] which relies on the custodian to provide fee income through agency securities lending. In reality, all custody clients stand along a sliding scale between the competing priorities of traditional custody and securities finance.

Arrangements serving one class, disservice to other

The pinch point is that the legal and operational arrangements that serve one set of priorities are, generally, a disservice to the other. The traditional individual segregation, look through and full entitlements are costly and (in market terms) inefficient to provide. They run counter to market liquidity, and deplete infrastructure capacity, both of which rely heavily on pooling and net settlement.[14] Conversely, arrangements facilitating securities finance also promote market liquidity and the smooth running of the infrastructure, but weaken the traditional investor's position. Pooling and PRIMA prevent the direct enforcement of its rights by the investor against the issuer.[15] TTCA and rehypothecation expose the investor to the credit risk of the securities finance provider, at least at the margin.[16]

10 The paradigm TTCA is a repo. In TTCA, on the opening of a trade, collateral is transferred outright to the collateral taker, so that (in contrast with a security interest) the collateral giver retains no residual property interest in the collateral asset. The delivery is subject to a contractual right to the return to assets equivalent to the collateral assets originally delivered (ie same type, same number, not necessarily the same ones) on closing.

11 Rehypothecation is the (misleadingly named) practice of a prime broker transferring client assets from a client account to its house account, and thereafter using them for its own purposes, subject to a contractual obligation to return equivalent securities to the client's account on request. Contractual rehypothecation rights are granted by hedge funds to their prime brokers as the *quid pro quo* of cheap credit.

12 Close-out netting is a procedure that operates upon default, and typically provides for all cross claims arising under trades within its scope to be (i) accelerated (so as to be immediately due and payable); (ii) converted into a contractual base currency; (iii) aggregated; and (vi) set off against each other, so that only a net sum is payable.

It is essential to each party to ensure that close-out netting rights are effective in the insolvency of the counterparty.

13 Funding pressures arise for a range of reasons, including demographic changes affecting pension funds and life insurers, new regulatory pressures affecting all regulated institutions, and the low interest rate environment.

14 Settlement means delivery. Pooled client accounts permit net settlement as follows. Where different clients of an intermediary instruct it to settle both buy and sell trades in the same asset, the intermediary can settle matching and opposite instructions across its own books. Only the excess of sales over purchases (or purchases over sales) must be settled externally at a CSD. The external settlement is called a net settlement.

15 With pooling, the interest of the individual custody client is recorded only in the books of the intermediary, and no record of that interest appears on the records of the CSD.

PRIMA is legislatively supported by a 'no look through' rule, which prohibits the attachment of the investor's interest other than at the level of the relevant intermediary's account.

16 Upon TTCA or rehypothecation, the property interest of the collateral giver or client is extinguished, and replaced by a personal right to the return of like assets. This is unsecured and, except to the extent of nettable cross claims, at risk in the insolvency of the counterparty or prime broker.

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Importance of efficient collateral delivery

Shadow banking comprises the markets in which credit (particularly short-term credit or liquidity) is raised against financial collateral (particularly securities collateral). The systemic importance of liquid collateral flows is emphasized in the recent ICMA[17] paper, *Collateral is the New Cash*.[18] Firms, infrastructures and central banks alike rely on securities finance to manage liquidity and systemic risks. The integrity and efficiency of the securities finance system is fundamental to the operation and safety of the financial system as a whole. But, if systemic risk management through efficient collateral delivery is a policy absolute, so is client asset protection. Neither ambition can be compromised, or prioritized above the other. The way out of such a Gordian knot is, of course, to sever it.

Client choice

I argue that the law and regulation of custody should bifurcate into two. Separate legal and regulatory regimes should be developed for traditional custody and client securities finance respectively. The guiding principle in such reforms should be the informed choices of sophisticated clients.[19] This should permit the resolution of issues that have proved intractable and controversial on a 'one-size-fits-all' basis.

Separate regulatory regimes

Traditional custody and client securities finance

Within the Financial Conduct Authority Client asset Sourcebook (CASS), a separate chapter should be developed for client securities collateral, distinct from the custody rules and considerably more developed than the existing collateral rules. The existing custody rules should be renamed, 'traditional custody rules', and adapted to reduce risk for the client.

Choice for non-retail clients

There should be a regulatory presumption that the assets of retail clients are subject to the traditional custody rules. Professional clients and eligible counterparties should be free to choose whether to require their assets to be held by the firm under the traditional custody, the client securities finance rules, or both in respect of different parts of their portfolios, according to their risk appetites and financing needs. Some will choose different intermediaries to deliver the different services. Custodian firms will offer one or both services according to their business models.

17 International Capital Market Association <http://www.icmagroup.org/> accessed 2 June 2014.

18 ICMA, *Collateral is the New Cash; the Systemic Risks of Inhibiting Collateral Fluidity*, April 2014 <http://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/short-term-markets/Repo-Markets/icma-european-repo-market-reports-and-white-papers/collateral-fluidity/> accessed 2 June 2014.

The growing mobilization of the institutional asset base held in custody as financial collateral in shadow banking is an historically significant development, economically analogous to the development of traditional, fractional reserve banking, whereby cash at bank is no such thing, but merely a promise. Our predecessors might have decided to shut down deposit taking banks, but we are all glad that instead, they decided to regulate them.

19 This is consistent with post-crisis EU provision that clients must be offered the choice between individually segregated and pooled client accounts (eg in EMIR, AIFMD and SLL). It is also consistent with the proposed regulation of securities finance and rehypothecation, based on transparency in the proposed Securities Finance Regulation <http://ec.europa.eu/internal_market/finances/docs/shadow-banking/140129_proposal_en.pdf> accessed 2 June 2014.

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This builds on the recommendation of Peter Bloxham[20] for 'virtual segregation' between securities held on a pure custody basis and those which may be charged to the firm.[21]

Rise of client securities finance

The development of a new substantive regulatory regime for client securities finance would reflect an important trend in the custody business model. This is the move away from pure safekeeping and administration, and towards securities finance. The trend reflects the funding pressures on custodians. With downward pressure on custody fees, the business model of the industry depends increasingly on the cross-selling of financial services, including agency securities lending, and secured finance. As well as being pushed, client securities finance arrangements are also pulled by the funding pressures facing institutional investors. Consistent with this is the significant rise in tri-party collateral services as a development of traditional custody.

Separate legal regimes

Substantive law reforms should also provide for two alternative sets of rules, with differing legal outcomes, and providing for client choice between them for sophisticated investors.

Traditional custody

Traditional custody rules should require that clients be given the option of individual client segregation, for a price reasonably reflecting operational costs. This accords with the EU position.

Choice of law

Consistent with traditional conflict of laws, the choice of law rule for property rights in client securities should follow the jurisdiction of the root of the client's title.[22] In the case of pooled accounts, this involves PRIMA. For individually segregated accounts,[23] this is 'look through' to the CSD jurisdiction.

In practice, providing for two different rules will not complicate portfolio collateral arrangements, because traditional custody securities are not permitted to be used to raise finance, and securities collateral in the financial markets will always be governed by PRIMA under client securities finance rules (see below).

The individually segregated clients should be given full client entitlements, again at a price reflecting operational costs, and subject to an option to agree a reduced and cheaper service.

20 Recommendation 53.

21 In practice, all custody portfolios will be subject to some security, whether arising contractually or by operation of law. As discussed in Section 3 below, the distinction proposed here is between portfolios charged only with the fees, expenses and overnight exposures routinely provided by traditional custodians, and the additional and more complex financing provided in securities finance.

22 The root of title is the documentary evidence of the client's ownership, in this case the name of the client in the account maintained by the intermediary.

23 Assuming segregation at CSD level.

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Client securities finance

Client securities finance clients might properly be limited to pooled accounts, PRIMA and a reduced level of contractual entitlements, consistently with the operational bases of liquidity and the usual commercial priorities of the parties.

This currently runs counter to EU legislation, to the extent that collateral arrangement comprises security rather than TTCA/rehypothecation. The conflict could be addressed, either by amending EU legislation under the proposed SLL, or restricting the regime to TTCA/rehypothecation arrangements.

2. Traditional custody

Derisked custody

By 'traditional custody' is meant safekeeping and administration, but without the key operational and legal risks that can affect client securities. Thus, the traditional custody regime would exclude: TTCA and rehypothecation; agency securities lending and the encumbrance of the portfolio with liabilities other than fees, expenses and the overnight liquidity that supports settlement[24] ('excluded arrangements').

Excluded arrangements would be permitted under the client securities finance regime and, to the extent that they are chosen by the parties, the affected assets should be governed by the client securities finance rules.

Traditional custody should be the default option for all clients, and either required or presumed for retail clients.

Specific targeted regulatory reforms only

Specific reforms

Specific existing and proposed reforms, including those proposed in the Bloxham Review and here, are appropriate and sufficient responses to the lessons of the financial crisis for traditional custody.

Fundamental model not broken

It is important to remember that the harrowing lessons of LBIE are related to client securities finance and not traditional custody. As discussed below,[25] a central factor in the LBIE client asset debacle was the complexity of the financing arrangements in which client assets were involved. In contrast, for traditional custody, the existing legal and regulatory model for client asset protection was not discredited in the financial crisis, and remains fundamentally fit for purpose.

24 Clients do not always pre-position with the custodian the cash and securities necessary to effect settlement. In order to ensure that settlement is delayed, it is customary for custodians to agree automatically to lend the cash and securities necessary to effect timely settlement.

25 s 14.

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Trust

Thus, the use of property rights under a trust remains a sound private law basis for client asset protection in traditional custody. The successful assertion of property rights involves attachment, or the identification of assets to support a property claim. In English law, property is an elastic concept, and can readily adapt to the many efficiency-driven market practices that may preclude linking particular clients to particular underlying securities in traditional custody, particularly pooling.[26] In relation to client money, the Bloxham Review recommendation to supplement this property basis with limited client preference (in relation to sums pending segregation under the alternative approach to segregation)[27] is welcomed, but it is not clear that further departures from the property basis of traditional client asset protection are merited.

Legal reforms for traditional custody

Because the use of traditional custody assets as collateral is extremely limited, law reforms to address legal risk in portfolio finance is correspondingly less urgent than for securities finance.

3. Client securities finance

Scope—securities finance involving (former) client assets

Use of client assets

The protections of the proposed securities finance regime would apply in two circumstances.[28] The first is where custody assets are encumbered with complex liabilities. The second is where TTCA or rehypothecation is used to remove client assets from the scope of the existing CASS/MiFID regime, and here the client securities finance rules would apply as a condition of so removing them.

Security interest and TTCA

Thus, the client securities finance regime should deal with client assets delivered as collateral to the firm by the custody client under both security interests (except in the case of the very limited secured liabilities permitted in traditional custody) and under TTCA.

No securities finance between market counterparties

Securities finance transactions arising out of this client asset context,[29] are arm's length dealings, not raising client asset protection issues. Acting as a party to TTCA arrangements does not *ipso facto*[30] involve custody. Systemic, but not client asset

26 *Hunter v Moss* [1994] 1 WLR 452.

27 *Bloxham Review*, 5.

28 Subject to the comments about EU legislation for choice of individual client segregation.

29 eg between two wholesale market participants.

30 Although tri-party collateral structures are common, in which a custodian holds collateral delivered between two trade counterparties. Hold in custody (HIC) repos are no longer common. Here, the collateral giver holds the collateral for the collateral taker (also known as 'trust me' repos).

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protection, concerns arise, and these are currently being addressed through proposals for transparency.[31]

Fundamental reforms needed

Radical and urgent

In contrast to traditional custody, with securities finance, client assets are either encumbered with complex liabilities or absent from the client asset pool under TTCA/rehypothecation arrangements. It follows that client protection can only be served by a fundamental change of regulatory direction. Further, international legal reforms are systemically more urgent because of the use here of client assets as collateral in the wholesale markets.

Lessons: complex financing

LBIE was a prime broker, and the fundamental cause of the LBIE client asset failures was the complexity of the financing for which the portfolio was used. While a number of other issues (particularly poor records) were implicated, the central problem was that insolvency officials were unable to quickly release available client assets, because they were unable to quickly ascertain net liabilities (in the UK) and net equity (in the USA). Client asset return was postponed to the complex and slow procedure of closing the prime brokerage course of dealings, including valuing hard to value positions;[32] obtaining close-out net sums for trading books that counterparties were not contractually obliged to close,[33] and ascertaining and confirming the discharge of the secured liabilities of associates.[34] Clients couldn't get the assets because officials couldn't get the numbers.

Asset encumbrance

Charge beneficial interest

The first aspect of this was asset encumbrance. As is customary, client assets were held by LBIE as custodian on trust for clients, and the client's beneficial interest under this trust was charged back to the custodian by the client to secure their liabilities to LBIE.

Extent not existence of charge

The problem was not so much the existence of asset encumbrance, but its precise extent.[35] The regulatory solution to this must ensure the continuous availability, and reliability as a basis for distribution, of a net liability/net equity figure.

31 In the proposed EU Securities Finance Regulation.

32 eg positions for which there is no (current) market.

33 See *Lomas v JFB Firth Rixson, Inc* [2010] EWHC 3372 (Ch).

34 Secured liabilities included those owed to group companies: see *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch).

35 Particularly third-party liabilities.

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Escalate regulatory status of net equity figure

Prime brokers continuously maintain such figures as part of their credit risk management, and the regulatory task will be fairly to escalate its status. Ensuring fairness might include procedures for publication to and verification by clients.

Valuation

It is also vital to ensure fair valuation, in view of the typically wide valuation[36] discretions enjoyed by prime brokers. In the case of TTCA/rehpothecation arrangements, no duty of reasonableness is implied.[37] Abuse was alleged in the financial crisis.[38]

TTCA/rehypothcation

The second aspect of client protection in client securities finance is title transfer and rehypothecation.

Securities finance rules as condition of TTCA/rehypothecation

Of course, the effect of these arrangements is to transfer full title away from the client, and thus to take client assets out of the scope of the custody trust, and the existing CASS/MiFID client asset regime. But the proposed requirements would apply as a regulatory condition of TTCA/rehypothecation.

The exposures of clients can only be addressed otherwise than by property rights.[39] The recommended course is to follow wholesale market solution to the same problem.

Credit risk/close-out netting

The chief exposure for the client is the credit risk of the firm. The wholesale securities finance markets address counterparty credit risk in securities finance transactions through close-out netting rights. Thus, the systemic integrity of the financial collateral (and therefore of shadow banking) rests primarily, not on property but on netting. The regulatory regime should follow suit.

One criticism of LBIE was the unavailability to clients of two-way events of default in its prime brokerage documentation.[40] This prevented clients from closing out, and setting their client asset exposures against LBIE's cross claims against them, so that they were obliged to wait for up to five and a half years for the return of their securities. A regulatory requirement for two-way events of default for rehypothecation and TTCA would free clients from the delays associated with the return of client assets, by enabling them to set off their value. Of course, this would be disruptive, and portfolio transfer is a

36 And also fair marking to market practice.

37 In the case of security interest, the secured creditor enforcing a power of sale has an implied equitable duty to obtain true market value: *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] 1 Ch 949. But no such duty applies in the case of valuation for the purpose of close-out netting in TTCA: *Socimer International Bank Ltd (in liquidation) v Standard Bank London Ltd* [2008] EWCA Civ 116.

38 [US Committee of Enquiry official report].

39 Former property rights cannot survive the absence of the asset: see eg *Re Diplock* [1948] Ch 465, 566.

40 I am grateful to Michael Raffan, Partner, Freshfieds Bruckhaus Deringer, for this point.

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better option, as the Bloxham Review emphasizes. But where transfer is not possible, close-out would in turn be better than the long delays associated with asset returns.

Client credit risk at the margin

Of course, clients would continue to bear credit risk to the extent of haircuts, or the excess of the value of their delivered collateral assets over that of their liabilities to the firm. It would be perverse to call for maximum limits on haircuts as part of client asset protection, when the Financial Stability Board (FSB) has called for minimum haircuts as part of systemic risk management.[41]

A commercial solution would require custodians/prime brokers to secure their (close-out) net obligations to clients. If correctly structured, such arrangements are legally robust. This practice is well established amongst sophisticated collateral givers.

Where possible,[42] such close-out provisions and security should be brought within the scope of FCAR (the financial Collateral arrangements Regulations 2003 (SI 2003/3226)).[43]

The effect of such requirements for close-out netting rights, supported security for close-out net sums, would be effective functionally to deliver client protection, outside the scope of the custody trust and the regulatory client asset regime. It would do so without recourse to insolvency preference through primary legislation, by following the existing market solutions.

In terms of fairness to creditors of the insolvent firm, such client protection is justified in order to prevent a windfall to the insolvent intermediary's creditors. Existing functional precedents for such client protection are provided by statutory insolvency preference for depositors and general insurance policyholders.

Derivatives margin as securities collateral, not client money

It may be convenient to regulate cash derivatives margin provided by clients under security interests as client securities finance (perhaps under the alternative term, 'client portfolio finance') rather than as client money.[44]

Reliance on close-out netting rights between the client and the firm could address the 'parallel claims' and 'hindsight' valuation problem arising in MF Global case law.[45]

Of course, EMIR porting requirements would need to be considered.

Systemic importance of the harmonized law reform: the legal matrix

An internationally harmonized legal regime for securities finance[46] is essential to enable securities collateral to fulfil its role in managing systemic risk in the wholesale markets.

41 <http://www.financialstabilityboard.org/publications/r_130829b.htm> accessed 2 June 2014.

42 Eg collateral arrangements with individuals are not within the scope of FCAR.

43 Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003/3226.

44 The author is grateful to Guy Morton, partner, Freshfields Bruckhaus Deringer, for this point.

45 *Heis v Attestor Value Master Fund LP and Solid financial Services Ltd* [2013] EWHC 2556 (Ch), *Heis v Attestor Value Master Fund LP and Schneider Trading Associates Ltd* [2013] EWHC 92.

46 Whether or not *client* securities finance.

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Special rules

The legal integrity of securities finance relies on a body of special rules, which vary the normal provisions of commercial law, so as to address legal risk in the wholesale market use of financial collateral. In this discussion, these provisions are called 'the legal matrix of financial collateral'. Key provisions are contained in the Financial Collateral Arrangements Directive, and related EU wholesale market measures.[47] Other provisions have been recommended in the Geneva Convention. Key elements include the recognition of close-out netting provisions in insolvency, and the use of PRIMA as a choice of law rule. The legal matrix is relied upon by market participants, infrastructures[48] and central banks[49] alike to manage credit and promote market liquidity. Although its core provisions reflect existing principles of English law,[50] its implementation internationally is incomplete, and existing measures have been criticized in some quarters.

Separate treatment of traditional custody

It is submitted that much of the resistance to the legal matrix is inspired principally by client asset protection concerns, and would be addressed by the recommended separate treatment of traditional custody and securities finance. The legal matrix would apply to the latter.

4. Conclusions

The merits of optionally

The optional availability of two distinct legal and regulatory regimes would offer a number of advantages. The existing conflict between client asset protection and wholesale collateral markets would be relieved. An effective regulatory response to the lessons of LBIE would be made without inhibiting wholesale market efficiency. The acute policy differences[51] currently affecting substantive law reform initiatives would be addressed.

Operational costs

A transition to two regimes for the custody industry would involve certain operational costs. However, some costs are inevitable and appropriate following LBIE.

Further, client choice and market forces are likely to reduce these costs in practice. The client securities finance regime will be operationally cheaper for the custodian, and this will be reflected in the pricing of the service to clients. With the effective management of client credit exposures to the firm, more clients are likely to choose to migrate to this regime, so that only the most risk-averse and/or active investors will remain in the

47 Settlement Finality Directive, Winding Up Directive (Banks), Winding Up Directive (Insurers), Insolvency Regulation.
48 Eg clearing and settlement systems.
49 In their open market operations.
50 Particularly mandatory insolvency set off under rule 4.90 of the Insolvency Rules 1986. Also, there are good arguments that PRIMA is compatible with existing choice of law rules in the case of pooled accounts.
51 Particularly concerning choice of law and entitlements.

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traditional custody regime. On this basis, it may be unusual to be obliged concurrently to comply with two regimes.

Borrowing wholesale market techniques

Wholesale market solutions to credit risk management (particularly close-out netting) have been developed over many years by financial institutions (and their advisers and trade associations) to protect their own capital. The legal and institutional resources that have been deployed to ensure their effectiveness are very considerable. As a result, they (unlike the UK existing client asset regime in the context of client securities finance) withstood the stress testing of the financial crisis.

It would be a smart move for regulators now to borrow these market tools, and apply them to their own objective of client asset protection.

Conclusions

The recommended development of separate regimes for traditional custody and client securities finance would provide a decisive response to the fundamental client asset lessons of LBIE. It would promote client choice, and draw on the technical solutions that have been successfully stress tested in the financial crisis.

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