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Client Asset Requirements for Investment Firms

Introduction

On 2 August 2013, the Central Bank of Ireland (“**Central Bank**”) published Consultation Paper CP 71 (“**CP 71**”) on proposed Client Asset Regulations and Guidance for investment firms and fund service providers (“**FSPs**”). Having considered the responses received to CP 71, the Central Bank took the decision to introduce two separate sets of regulations, one for investment firms and another for FSPs. This briefing deals with the regulations which apply to investment firms only and is relevant to investment business firms which hold client assets.

On 30 March 2015, the Central Bank published a set of regulations; the Client Asset Regulations 2015 for Investment Firms¹, (the “**Client Asset Regulations**” or the “**Regulations**”) which aim to strengthen the safeguards around client assets held by investment firms.

The Central Bank has also published guidance (“**Guidance on Client Asset Regulations for Investment Firms**”) to assist investment firms to comply with the Client Asset Regulations. The Client Asset Regulations will come into operation on 1 October 2015 and will replace the existing Client Asset Requirements (issued 1 November 2007) from that date.

¹ S.I. No. 104 of 2015

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On the publication of the Regulations, Director of Markets Supervision, Gareth Murphy, said "*The publication of these Regulations marks a significant development with regard to the safeguarding of client assets and investor money in Ireland. The development of these Regulations is the outcome of a lengthy period of industry consultation with investment firms and funds service providers. The Central Bank will closely monitor the implementation of these Regulations so as to ensure that our aim of enhancing investor protection and safeguarding client assets is achieved.*"

Who do the Regulations apply to?

The Client Asset Regulations apply to investment firms when holding client assets² and as such may apply to investment firms authorised under MiFID Regulations³, investment business firms authorised under the Investment Intermediaries Act 1995 (as amended) (the "IIA")⁴, UCITS management companies authorised to provide individual portfolio management activities and Alternative Investment Fund Managers authorised to provide individual portfolio management activities.

The Client Asset Regulations would also apply to an Irish authorised firm which passports its activities into another Member State, however, the Client Asset Regulations will not apply to an incoming investment firm which passports into Ireland (either on a freedom of service or branch basis).

Client Asset Regulations

The Client Asset Regulations are set out under seven headings which the Central Bank regards as the seven core client asset principles of the client asset regime:

1. Segregation

An investment firm should physically hold, or arrange for the holding of, client assets separate from the firm's own assets and maintain accounting segregation between the firm's own assets and client assets.

The Client Asset Regulations provide that money received by an investment firm for investment in an activity that is not a regulated financial service should not be deposited in a client asset account. If an investment firm chooses to operate a client asset type regime for its non-regulated business, the investment firm must explain to its clients that such assets;

- (a) Are held separately from client assets;

² The term client assets is defined in S.I. No. 104 of 2014 as meaning client funds and client financial instruments.

³ S.I. No. 60 of 2007

⁴ The definition of "investment firm" which is contained in the Client Asset Regulations specifically excludes a person authorised under the IIA to solely carry out; (i) the administration of collective investment schemes or fund accounting services or acting as a transfer agent or registration agent for such schemes or (ii) custodial operations involving the safekeeping and administration of investment instruments; i.e. the definition specifically excludes fund administrators and depositaries authorised under the IIA.

- (b) Will not be protected as client assets; and
- (c) Will not be covered under the Investor Compensation Scheme.

2. Designation and Registration

An investment firm should ensure that client assets are clearly identified in its internal records and in the records of third parties. Those assets must be identifiable from the investment firm's own assets.

Under the Client Asset Regulations a firm should obtain a "Fund Facilities and Financial Instrument Facilities Letter in advance of opening a client asset account with a third party in respect of client funds. This letter is meant to govern the relationship between the firm and the third party.

3. Reconciliation

An investment firm should keep accurate books and records to enable it at any time and without delay to provide an accurate record of the client assets held by the investment firm for each client and the total held in the client asset account. In addition, an investment firm should perform a reconciliation between its internal records and those external records of any third party with whom client assets are held as provided for in the Client Asset Regulations. The Guidance on Client Asset Regulations for Investment Firms explicitly states that fixed term deposits should be reconciled on a monthly basis.

Under Regulation 5(10) of the Client Asset Regulations, an investment firm shall commence an investigation into the cause of any difference in the reconciliation within one working day, shall identify the cause of the reconciliation difference within 5 working days and shall resolve any reconciliation difference identified as soon as practicable.

4. Daily Calculation

Each working day, an investment firm should ensure that the aggregate balance on its client asset bank account as at the close of business on the previous working day is equal to the amount it should be holding on behalf of its clients. The Client Asset Requirements therefore eliminate the requirement upon firms to retain a buffer; (i.e. a firm's Client Money Resource should only contain what it is required to hold for its clients on a given day).

5. Client Disclosure and Client Consent

An investment firm should provide information to its clients in a way that informs the client on how and where their client assets are held and the resulting risks thereof. Under the Client Asset Regulations a firm will be required to provide a Client Assets Key Information Document ("**CKID**") to retail clients. In addition, a firm should be able to demonstrate, when requested to do so, evidence that it provided the CKID to its retail clients. The Client Asset Regulations also specify the

circumstances when an investment firm should obtain consent in writing from its clients - such circumstances include; (i) where client assets are passed to a third party outside the State or the EEA; (ii) when client assets are to be held in a pooled account; and (iii) where any lien, security interest and/or right of set-off is granted over the client's assets.

6. Risk Management

An investment firm should ensure that it applies systems and controls that are appropriate to identify risks in relation to client assets and should put in place mitigants to counteract these risks.

Under the Client Asset Regulations an investment firm will be required to appoint an individual to the role of Head of Client Asset Oversight Role ("**HCAO**"), who will be responsible for ensuring that the firm complies with its obligations under the Client Asset Regulations. This person will be a pre-approved controlled function ("**PCF**") under Part 3 of the Central Bank Reform Act 2010. The responsibilities of the HCAO should be tailored to the business model of the firm.

Firms that hold/intend to hold client assets will be required to adopt a Client Asset Management Plan ("**CAMP**"). The CAMP will be required to be reviewed and updated at least annually or more frequently if there is a change to a firm's business which effects the way in which client assets are held by the firm. The Client Asset Regulations contain detailed rules as to what should be included in the CAMP.

7. Client Asset Examination ("**CAE**")

An investment firm should engage an external auditor to report at least on an annual basis on the investment firm's safeguarding of client assets. Under the new regime the auditor must provide an assurance report with regards to certain matters which are specified in the Client Asset Regulations.

Conclusion

The Client Asset Regulations will ensure that investment firms will have stronger systems and controls in place to protect the ownership rights of clients. In addition investment firms will have a process in place which, in the event of insolvency, will facilitate the expeditious return of client assets. It is hoped that the revised regime will prevent a repeat of cases such as MF Global, Lehman Brothers and Custom House Capital in Ireland where individual investors lost significant amounts of money.

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