



The evolving CAR

Introduction & Background

The protection of client assets continues to be a priority for the Central Bank of Ireland ('Central Bank'). The client asset regime which was introduced in 2007 (Client Asset Requirements¹), and revised in 2015² (Client Asset Regulations (CAR)), ultimately aims to maintain public confidence, minimise the risk of loss/misuse of client assets and protect investors in the event that an investment firm was to become insolvent. Whilst the current client asset regime, serves to protect client assets held by MiFID investment firms, it does not extend these protections to institutions who are authorised as credit institutions carrying

out MiFID investment services. Failures in the client asset control environment within investment firms and credit institutions can have serious consequences for clients, and in the event of an investment firm's failure may result in the misuse, misappropriation, loss or delays in returning client assets, which would also be harmful from a reputational perspective to the Irish financial market.

The post-Brexit Irish financial services industry is evolving as a whole, and more particularly the client asset environment, with ever increasing values of client assets being held by increasingly complex

investment firms. With the emergence of new, more complex firms, carrying out more sophisticated activities, the Central Bank is of the opinion that it is prudent to propose a number of enhancements to ensure that client assets held by investment firms, or credit institutions are appropriately safeguarded.

The Central Bank issued a consultation paper in December 2020, seeking views from stakeholders on the proposed enhancements to CAR³. The consultation period will run until 10 March 2021.

1 SI No 60 of 2007

2 SI No 104 of 2015 - Central Bank (Supervision and Enforcement) act 2013 (Section 48(1)) Client Asset Regulations 2015 for Investment firms

3 <https://www.centralbank.ie/publication/consultation-papers/consultation-paper-detail/cp133---consultation-on-enhancements-to-the-central-bank-client-asset-requirements-as-contained-in-the-central-bank-investment-firms-regulations>

The main proposed enhancements include:

- Extending the scope and application of the CAR to include credit institutions undertaking MiFID investment business;
- Introducing new requirements regarding client disclosure and consent, including enhancements applicable to investment firms that have obtained client consent to the use of client financial instruments and investment firms providing prime brokerage services;
- Introducing new CAR guidance to clarify the Central Bank's expectations as to how client funds should be segregated;
- Introducing new requirements, and placing some existing CAR guidance on a legislative footing, in relation to the performance of reconciliations and the treatment of client asset discrepancies and reconciliation differences, and shortfalls and excesses; and
- Introducing new requirements and CAR guidance on the contents of the Client Asset Management Plan (the CAMP).

Proposed Enhancements

Application of CAR to Credit Institutions carrying out MiFID activities

Whilst credit institutions who carry out MiFID activities, are subject to MiFID II 'safeguarding of client assets rules', they are not subject to the additional Irish client asset rules, CAR. With the increasingly complex nature of the credit institutions carrying out MiFID activities in Ireland, and the scale of the client assets they hold, there is a need to apply the highest levels of protection and reduce the risk of client exposure. There is also the need to 'level the playing field' for all entities holding client assets.

The Central Bank is proposing to achieve this increased protection of investors by extending the definition of "investment firms" in CAR³ to include credit institutions. Any credit institution that undertakes MiFID activities will thus be required to comply with the CAR in addition to the MiFID II 'safeguarding of client assets rules' that they already apply.



Whilst investment firms are generally required to deposit client funds within one working day, this does not apply to credit institutions, authorised under CRD for deposit taking. The Central Bank are proposing that under the enhanced CAR, additional obligations will fall on credit institutions availing of this 'banking exemption', in regards to disclosure. The credit institution in this case must prior to providing MiFID services to a client, disclose in its terms of business:

- A. That the funds are being held as deposits, as opposed to 'client funds'; and
- B. The instances where the funds will cease to be deposits and instead be held as 'client funds'.

The extension of scope of CAR will require credit institutions to consider their current operational arrangements and identify what enhancements (and in some cases totally new processes) are required to the control environment in order to fully comply with CAR.

The Central Bank in its consultation paper deemed two implications worth noting for credit institutions who will fall in scope of CAR, these are:

- The increase in the levy that the credit institution pays the Central Bank for the performance of their function as a

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regulator. All firms who are authorised to hold client assets are subject to this supplementary levy. Credit institutions who are subject to CAR, will also be required to pay a supplemental levy to the investor compensation scheme; and

- The appointment of a Head of Client Asset Oversight (HCAO) PCF-45. All firms who are authorised to hold client assets are required to appoint an individual with an oversight role to ensure the safeguarding of client assets. This individual must be sufficiently removed from the day-to-day performance of the client asset controls in order to effectively and independently discharge their oversight role.

Disclosure and consent

The increases in both the volume of client assets and the complexity of the activities being undertaken, particularly in the wholesale market, has led to concerns by the Central Bank in regard to client disclosures, and consent to use client assets for the benefit of the firm. The activities, which give rise to this concern, and will therefore, have increased consent and disclosure requirements include:

- **Securities financing:** Where the firm proposes to use client financial instruments, for the benefit of the firm, or another client through securities financing arrangements, then prior express consent will be required, and must be maintained. The firms Client

Asset Key Information Document (CAKID), may also need to be updated;

- **Title Transfer Collateral Arrangements (TTCA):** TTCA refers to the transfer of ownership from the client to the firm, meaning assets will fall outside the scope of CAR and MiFID II. The enhanced CAR will include provisions relating to the establishment and termination of TTCA; and

- **Prime Brokerage services:** Given the nature of prime brokerage services, in which the firm may take ownership of client assets during the course of providing services, with the assets therefore falling in and out of scope of CAR on a frequent basis, the Central Bank felt it important to update clients on a regular basis with regard their assets. Clients can therefore accurately manage their exposures, when they have given the firm consent to use their assets. The Central Bank is proposing that firms must disclose on a daily basis information regarding client asset holdings in the context of prime brokerage business.

The Central Bank is also proposing enhancements to CAR and CAR guidance in relation to the transfer of business and uncontactable clients.

The impact of the enhancement to the principle of 'disclosure and consent' on firms, will depend on the nature of the

activities undertaken, with more complex activities resulting in greater disclosure and consent requirements.

Segregation

The principle of segregation, is concerned with firms holding client assets separate from firm assets, and maintaining accounting segregation between firm assets and client assets (also segregation between clients). Under the enhanced CAR the Central Bank is proposing to clarify the CAR guidance in relation to Regulation 49(3), which provides that an investment firm must deposit client funds in a third party client asset account bank 'without delay, and in any event not later than one working day after the receipt of such client funds'. As we mentioned earlier this would not apply to CRD authorised credit institutions, availing of the 'banking exemption'. The Central Bank are proposing to clarify in the CAR guidance that client funds should be deposited directly into a client asset account. This could have potential ramifications for firms who receive client funds into non-segregated accounts, and subsequently, within one day, move those client funds to client asset accounts. A potential area of concern would be if an unexpected dividend were to be received into a firm account, usually the firm would have one day to identify this dividend as client funds, but under revised CAR guidance, this would not be appropriate.

Reconciliation and calculation

Under the principle of reconciliation, firms must conduct regular reconciliations between its internal records, and the external records of the third party where client assets are deposited. The Central Bank is proposing the following enhancements to the reconciliation process:



Internal 'client financial instrument' reconciliation

The Central Bank propose the introduction of an internal client financial instrument reconciliation, which would be a comparison between the firms internal client ledger (which determines the client financial instrument entitlements) and its internal custodian ledger (which determines the aggregate record of client financial instruments deposited in third party client asset accounts). This requirement would be similar to the current 'client funds daily calculation', which is effectively an internal reconciliation. The Central Bank is however proposing that the internal client financial instrument reconciliation need only be completed on a monthly basis, as is the case for the external client financial instrument reconciliation.



External reconciliation for 'client financial instruments' not deposited with a third party

This proposed enhancement from the Central Bank, seeks to put existing CAR guidance on a legislative footing. This amendment would require firms to conduct an 'external' reconciliation of client financial instruments not deposited with a third party, using statements obtained from those entities responsible for maintaining the record of legal entitlement to those client financial instruments. This reconciliation would be carried out on a monthly basis in line with all other client financial instrument reconciliations.



The reconciliation of physical client financial instruments

Similarly to the external reconciliation for 'client financial instruments' not deposited with a third party, the Central Bank propose to put the reconciliation of physical client financial instruments on a legislative footing. Whilst the Central Bank would have expected firms to carry out a reconciliation of physical client financial instruments held in a safe or otherwise by the firm, this enhancement will expressly require the firm to do so.



The treatment of client financial instruments differences or discrepancies

In line with the existing requirements for firms to investigate any discrepancies, which arise in the client financial instruments reconciliation, the Central Bank is proposing that this requirement be extended to any reconciliation process that is amended or introduced under the enhancements to CAR. As per existing requirement, the firm must identify the cause of any reconciliation difference must be identified within five working days and the reconciliation difference must be resolved as soon as practicable.



The treatment of client financial instrument shortfall and excesses

As the internal client financial instrument reconciliation is a new requirement, there are no existing guidance/requirements as to how to deal with a shortfall or excess arising from this reconciliation. The Central Bank is proposing that, similarly to the daily client funds calculation, in the event of a shortfall the firm must deposit funds, financial instruments or a combination into the relevant third party client asset account in order to cover the shortfall. In the event of an excess, the firm should remove client financial instruments as necessary to address the excess. Whilst this is similar to the daily funds calculation, firms have 3 days (allowing time for timing differences etc to rectify themselves), to rectify the excess/shortfall in this instance as opposed to 1 for the daily funds calculation.



Record-keeping requirements in respect of client asset reconciliations

The Central Bank is proposing that all investment firms maintain a record of the actions it has taken in respect of the remediation of a reconciliation difference or discrepancy.

The Central Bank has also proposed amendments to the daily calculation, to align the process for the remediation of client funds differences or discrepancies identified through the performance of the daily calculation with the process for remediating reconciliation differences. Under the current process, any differences in the daily calculation, which result in an excess or shortfall, are remediated through funding or removal of client funds from the client asset account. The proposed enhancement would require firms to investigate and resolve the cause of the difference, as opposed to just resolving the difference through funding or removal.

CAMP

The CAMP is an investment firms 'master' document in the context of documenting client asset arrangements, risks and

mitigations. The content of a CAMP will vary depending on the nature, scale and complexity of an investment firm's business model. The CAMP should be designed as a 'living document', which should reflect the firm's client asset arrangements in a single document. The content of the CAMP should be sufficient to enable an independent reader (insolvency practitioner) to understand the client asset arrangements and facilitate the orderly return of client assets in an insolvency event. To further enhance the CAMP, the Central Bank is proposing the introduction of a requirement for firms to include a 'Client asset applicability matrix', which would identify where client asset responsibilities arise across a firm's various services and business lines. This is similar to a 'good practice' identified by CAST in an industry letter issued in 2017 regarding the

implementation of the 'risk management principle'. In this communication, they referenced the applicability of CAR to various services offered by the firm 'Documenting in the CAMP when products/services are deemed to be in or out of scope of the CAR, and capturing the rationales for these key judgements'.

The Central Bank is also proposing to enhance the outsourcing requirements contained in the CAMP, to include a section that identifies all entities to which an investment firm outsources any activity relating to the safeguarding of client assets and details of how the investment firm proposes to exercise oversight of the activities. Previously the outsourcing requirement to be included in the CAMP applied only to the performance of the reconciliation and/or the daily calculation.

Key Impacts and Conclusion

The proposed enhancements serve to further demonstrate the importance the Central Bank places on the protection of client assets and as such there is an expectation that this importance is reflected in firms client asset systems, controls and governance frameworks.

- For some firms these enhancements will be straightforward, and can largely be incorporated into their current client asset control environment.
- For other firms currently subject to CAR, the enhancements will require updates and additions to the current systems and controls.
- For certain credit institutions, who carry out MiFID services, this will be a significant departure from their current arrangements and will require significant investment in systems and controls for the client asset environment.
- The Board of directors of all firms should be educated on the new rules and the impact they will have.
- Firms should consider how these rules will affect their risk universe, in line with the 3LOD model (i.e. effect on Risk function/Internal Audit).

Deloitte has provided investment firms with advisory services for Client Asset's in a number of areas including; impact assessment of revised CAR, development of the CAMP, authorisation support, control enhancements, and conducting client asset examinations. In Deloitte we can leverage tried and tested methodologies in relation to impact assessments and gap analyses of the proposed revised requirements.



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