

Justification for Retention under Article 4 of 2006/73/EC

MiFID Client Money – Additional Rules to address specific risks to investor protection or to market integrity that are of particular importance to the Irish state and are not adequately addressed by the MiFID.

Safeguarding client assets is a fundamental component of investor protection under the MiFID. Specifically MiFID seeks to protect client assets through general provisions requiring firms to make adequate arrangements to safeguard clients' ownership rights of both financial instruments and funds held by an authorised firm on behalf of a client. Safeguarding client assets has always been an essential component of client protection in Ireland particularly in light of failures by firms and losses incurred by clients. The Irish Financial Regulator has previously issued rules under Section 52 of the Investment Intermediaries Act, 1995 and the Stock Exchange Act, 1995 ("the Acts"¹) in order to make adequate arrangements for instruments and funds belonging to investors with a view to safeguarding investors' rights - the Client Money Rules ("CMR"). All firms authorised under the Acts to hold client money are currently subject to the CMR.

Certain of the current CMR do not appear to have a corresponding provision under the new MiFID regime. In this regard it is noted that under Recital 7 of the MiFID Implementing Directive (2006/73/EC) "*Member States should not add supplementary binding rules when transposing and applying the rules specified in this Directive save where this Directive makes express provision to this effect.*" However under Recital 8 "*in exceptional circumstances it should be possible for Member States to impose requirements on investment firms additional to those laid down in the implementing rules. However such intervention should be restricted to those cases where specific risks to investor protection or to market integrity including those related to the stability of the financial system have not been adequately addressed by the Community legislation, and it should be strictly proportionate.*" Additionally under Article 4 "*Member States may retain or impose requirements additional to those in this Directive only in those exceptional cases where such requirements are objectively justified and proportionate so as to address specific risks to investor protection or to market integrity that are not adequately addressed by this Directive, and provided that the specific risks addressed by the requirements are of particular importance in the circumstances of the market structure of that Member State*" and "*Member States shall notify to the Commission any requirement which it intends to retain before the date of transposition of this Directive*".

¹ The Acts transpose the provisions of the Investment Services Directive 93/22/EEC into Irish law.

Article 4 Notification:

The Irish Financial Regulator is proposing to retain the following CMR under the above Article 4 notification:

The current rule is listed and this is followed by the justification to retain the rule

Assets to be held with an Eligible Credit Institution, Relevant Party or Eligible Custodian (Current CMR - 3)

3.1 - Client assets may only be passed to other persons on the written instructions of the client concerned.

Justification for Retention – *This requirement is considered necessary in the interests of the protection of the client and of the firm in order to ensure the client is adequately informed as to the treatment of client assets. Additionally this requirement ensures that the client's beneficial interest in the assets held for the client on behalf of the firm is maintained.*

3.7 - Before client assets are lodged to a client account with an eligible credit institution, relevant party or eligible custodian, the firm is required to have received written confirmation from the institution concerned:

- (a) that all client assets are held by the firm as trustee and that the eligible credit institution, relevant party or eligible custodian is not entitled to combine the account with any other account or to exercise any right of set-off or counterclaim against assets in that account in respect of any sum owed to it by any person except:
 - (i) to the extent of any charges relating to the administration or safe-keeping of that client's investment instruments ; or
 - (ii) where that client of the firm has failed to settle a transaction by its due settlement date;
 - (b) that the credit institution, relevant party or eligible custodian will designate the account in its records in such a way as to make it clear that the client assets do not belong to the firm and are subject to the provisions of Section 52 of the Investment Intermediaries Act, 1995 or Section 52 of the Stock Exchange Act, 1995, as appropriate. In the case of non-Irish credit institutions, relevant parties or eligible custodians it will be sufficient for the acknowledgement to confirm that the title of the account sufficiently distinguishes the account from any account containing assets that belong to the firm;
 - (c) that it will not permit any withdrawal of any client assets held for safe-keeping other than to the firm or on the firm's instructions;
 - (d) that the relevant party or eligible custodian may only claim a lien or security interest over an individual client's investment instruments:
 - (i) to the extent of any charges relating to the administration or safe-keeping of that client's investment instruments; or
 - (ii) where that client of the firm has failed to settle a transaction by its due settlement date;
 - (e) of the procedures and authorities for the giving and receiving of instructions.
- A copy of this written confirmation shall be retained by the firm.

Note: Although this requirement is being maintained it is proposed that it will be separated in respect of client funds and client financial instruments in order to avoid confusions. This is considered to be in the best interest of clients. Therefore client 3.7 has been moved to **Requirement 5.2 – Written Confirmations** in respect of client funds and the relevant provisions for financial instruments are included in **Requirement 18 – Custodian Agreements**.

***Justification for Retention** – The Irish Financial Regulator considers that it is necessary in order to ensure the protection of client assets and to ensure that the third party to whom the client assets have been passed will comply with the provisions of the CMR that the above confirmations are obtained before client assets are passed to the third party. This is necessary in order that a client can continue to avail of the protection regarding the safeguarding of client assets provided under the MiFID regime and to ensure that a client’s beneficial interest in the funds is protected.*

Transactions involving Collateral including Margined Transactions (Current CMR - 10)

- 10.1 Before a margin account is opened by the firm, with an eligible credit institution, relevant party or eligible custodian, on behalf of a client or clients, the firm must comply with the procedures laid down in Requirement 3.
- 10.2 The firm is required to ensure that a client’s assets held in respect of margin account transactions are kept in a separate account to other assets held on behalf of that client.
- 10.3 Before the firm deposits the collateral with, pledges, charges or grants a security arrangement over the collateral to, an eligible credit institution, relevant party or eligible custodian, it must:
 - a) obtain the client’s prior written consent;
 - b) obtain the client’s consents referred to in Requirement 10.4 below, where applicable;
 - c) undertake an appropriate and continuing risk assessment of the eligible credit institution, relevant party or eligible custodian with whom the firm proposes to deposit the collateral, or pledge or charge or grant a security arrangement over the collateral;
 - d) notify the eligible credit institution, relevant party or eligible custodian that the firm is under an obligation to keep this collateral separate from the firm’s collateral;
 - e) instruct the eligible credit institution, relevant party or eligible custodian that:
 - (i) the value of that collateral passed by the firm on behalf of clients is to be credited to the firm’s client transaction account with that party; and
 - (ii) in the case where that collateral is passed to an intermediate broker and the initial margin has been liquidated to satisfy margin requirements, the balance of the sale proceeds must be immediately paid into a client account; and
 - (iii) in the case where the collateral is passed to an exchange or clearing house, the sale proceeds are to be dealt with in accordance with the rules of the relevant exchange or clearing house;
 - f) ensure that client’s fully paid (non-collateral) and margin account investment instruments will be held in separate accounts and that no right of set-off will apply;
 - g) notify the client that the collateral will not be registered in the client’s name, if this is the case;
 - h) notify the client of the procedure which will apply in the event of the client’s default where the proceeds of the sale of the collateral exceeds the amount owed by the client to the firm;
 - i) notify any eligible credit institution, relevant party or eligible custodian holding the collateral that; –
 - (i) the collateral does not belong to the firm; and
 - (ii) the eligible credit institution, relevant party or eligible custodian must not claim any lien or right of retention or sale over the collateral except to cover the obligations to the eligible credit institution, relevant party or eligible custodian which gave rise to that deposit, pledge, charge or security arrangement or any charges relating to the administration or safekeeping of the collateral.
- 10.4 The firm must have prior written consent from its client if it proposes to return to the client, collateral other than the original collateral, or original type of collateral. This does not preclude the firm from returning the cash equivalent where the collateral matures.
- 10.5 (a) The firm must not, without the prior written consent from the client, use collateral in the form of a client’s investment instruments as security for the firm’s own obligations.

(b) The firm must never use collateral in the form of a client's money as security for the firm's own obligations.

(c) The firm must not use a client's collateral as security for the obligations of another client or another person unless the criteria set down in Requirement 2.6 are fulfilled in full.

10.6 A firm need not obtain written consent from a professional client under Requirements 10.3 to 10.5 if prior written notice has been given by the firm.

***Justification for Retention:** – The treatment of collateral (money or an investment instrument that has been paid for by the client which is held by the firm as security for amounts which may be due to the firm by a client under the terms of a deposit, pledge, charge or other security arrangement) is not specifically dealt with under the MiFID regime for the safeguarding of client assets. Therefore the Irish Financial Regulator considers that it is necessary in order to ensure the protection of client assets and to ensure that the third party to whom the client assets have been passed will comply with the provisions of the CMR that the client can continue to avail of the protection regarding the safeguarding of client assets provided under the MiFID regime where the client assets have been provided as collateral as these assets are considered to remain the property of the client. Explicit client consent as to the treatment of collateral is necessary in order to ensure the protection of all parties involved. Formal client consent ensures that a client is aware of the manner in which his or her funds are being treated. Additionally it is important that clients are provided with the level of detail set out above as this ensures that all clients are adequately aware of the risks involved in the manner in which the funds are held.*

Payment of Client Money into a Client Account with an Eligible Credit Institution or Relevant Party (Current CMR - 11)

A firm shall pay its own money into a client account if required to do so by the Financial Services Regulator (11.6).

***Justification for Retention:** In order to safeguard client assets a firm should be required to make good any shortfall that occurs as a result of the firm's actions.*

Daily Calculation (Current CMR - 12)

Every business day a firm must ensure that its internal records confirm that the amount held in accounts maintained in accordance with Section 52 of the Investment Intermediaries Act, 1995 or Section 52 of the Stock Exchange Act, 1995² as appropriate (namely A) is at least equal to the amount it should be holding for clients (namely B). This calculation must be carried out, and any necessary funding (arising where A is less than B) deposited, by the close of business on the business day following the business day to which it relates.

B) shall be the sum of (C) and (D) calculated as set out below:

² The Investment Intermediaries Act, 1995 and the Stock Exchange Act, 1995 transpose the provisions of the Investment Services Directive into Irish Law. These references will be updated to reflect the national legislation that will be used to transpose the MiFID into Irish law.

(C) shall be the aggregate of the following amounts calculated for each *client*³ where the aggregate is positive:

- (i) that *client*'s cash balance as per the firm's own records;
- (ii) the balance on that *client*'s transaction account with the firm including:
 - balances in respect of *transactions* for the sale of securities which have settled the proceeds of sale which are due to the *client* where the *client* has delivered the securities;
 - balances in respect of *transactions* for the purchase of securities the proceeds which have been received from the *client* and where the *transaction* has not yet settled;
 - the balance on that *client*'s *margin account*;
 - dividends or interest due to the *client*;
 - any other relevant amounts; and
- (iii) the value of that *client*'s *collateral* that takes the form of cash.

(D) shall be calculated in accordance with Requirement 12.3.

Firms will be required to maintain in the *client account*, in addition to the amount of (C) calculated in accordance with Requirement 12.2, an amount equivalent to 8% of the average level of *settled debtors* over the preceding five *business days* which amount shall be called (D).

Where a firm deems it prudent in the interests of the protection of *clients* it must deposit its own *money* into a *client account*.

A firm must immediately notify the Financial Services Regulator of any deposits under Requirements these requirements which exceed 0.5 per cent of (C) as calculated in accordance with the above together with the reason for such deposit.

Failure to Perform Calculation (13)

A firm must notify the Financial Services Regulator immediately, and confirm in writing, where it has been unable or has failed to perform any or all aspects of the calculation required by Requirement 12.1 within the timeframe permitted by that requirement.

Justification for Retention: The daily calculation shows a comparison of the total money held for clients with credit institutions in client money bank accounts as per the records of the firm to the total owed back to clients by the firm and the overall surplus/deficit. The purpose of the Daily Calculation is to ensure that there is sufficient money in the client bank accounts to pay monies owing to clients ("positive balances"). In ensuring this firms are not allowed to take into account monies owing to them by clients ("negative balances"). This is because in the event of a liquidation it is not certain that all clients owing money would pay up and the client bank accounts would therefore be in deficit. The purpose of the "buffer" (D) is to allow for the fact that the Daily Calculation is calculated a day in arrears and to provide a "safety net" for any movements on the accounts. If for example a firm went into liquidation at 2 pm, the most recent Daily Calculation would have been for close of business the previous day, the buffer provides at least to some degree for movements on the account on the morning in question.

The Irish Financial Regulator considers that this is a key calculation in order to ensure that there is sufficient client money available in the event of an insolvency event affecting the firm.

³ This does not prevent netting but ensures that one *client's assets* are not used to fund another *client's transactions*.

It is important that a firm holding client money is required to complete this calculation on a daily basis and that the Irish Financial Regulator is informed of any instance that would give rise to the calculation not being performed or where completion of the calculation has resulted in the requirement for the firm to deposit its own funds over a certain threshold into the client account. The requirement to produce a daily calculation provides a strong safeguard of client assets. A high degree of importance is attached to the firm's compliance with this requirement as evidenced by the requirement that the firm's external auditors report at least once a year to the Irish Financial Regulator whether or not a firm complies with this requirement among others. Additionally inspections of investment firms would always give priority to checking this aspect of a firm's compliance with the CMR.

Custodian Agreements (Current CMR - 18)

Before a firm opens an account for client investment instruments with a relevant party or eligible custodian either in or outside Ireland it must have notified the institution concerned, in writing, and received an acknowledgement, in writing, from the institution:

- (a) that the account will be designated in such a manner that makes it clear that the investment instruments credited to it are client investment instruments;
- (b) that the relevant party or eligible custodian is not permitted to withdraw any client investment instruments from the account otherwise than to the firm or on the firm's instructions;
- (c) that the relevant party or eligible custodian will hold and record client investment instruments separate from its own investment instruments
- (d) of the extent of the eligible custodian's liability in the event of the loss of client investment instruments whether caused by the fraud, wilful default or negligence of the eligible custodian or otherwise, or an agent appointed by the eligible custodian;
- (e) of the arrangements for registration of client investment instruments if these will not be registered in the client's name;
- (f) of the arrangements for claiming and receiving dividends, interest payments and other rights accruing to the client;
- (g) of the arrangements for exercising conversion and subscription rights;
- (h) of the arrangements for dealing with take-overs, other offers or capital re-organisations; and
- (i) of the arrangements for exercising voting rights.

A copy of this written confirmation shall be retained by the firm.

Note: This requirement has been amended to take into account those elements of Requirement 3.7 that relate to financial instruments. This is to ensure that firms are only required to obtain one confirmation where the firm has opened an account into which it deposits, or proposes to deposit client financial instruments.

***Justification for Retention:** The requirement to obtain the consents detailed above is considered necessary in order to ensure that the financial instruments held on behalf of the client with relevant party or eligible custodian will be held under the client asset regime. The requirement to obtain explicit consent ensures the protection of all parties involved, including the client, the firm holding assets on behalf of the client and the third party with whom the assets have been deposited.*

Securities Lending (Current CMR - 19)

A firm must not undertake or otherwise engage in stock lending with or for a client except where:

- (a) each relevant private client has been advised of the risks associated with this activity and has acknowledged this in writing;
- (b) the firm has received written confirmation from the client either of counterparty credit ratings acceptable to him/her or that he/she does not wish to specify such rating; and
- (c) the firm ensures that
 - collateral is provided by the borrower in favour of that client;
 - the current realisable value of the investment instrument and of the collateral is monitored daily; and
 - where the current realisable value of the collateral falls below that of the investment instruments concerned, the firm has arrangements in place to provide further collateral to make up the difference.

Any cash or other assets held in favour of a client as collateral for securities lending must be held in accordance with these Requirements.

***Justification for Retention:** The requirement to advise each private client⁴ of the risk associated with securities lending ensures that the client is fully aware of the risks to which the client is subject. Additionally by requiring the explicit confirmation from the client of the credit ratings acceptable to the client the client has specified the risk level that may be incurred. Also it is considered prudent and in the interest of safeguarding the value of the client's portfolio that any collateral received is monitored daily and that any that further collateral is requested where applicable.*

Conclusion

The Irish Financial Regulator wishes to retain the CMR detailed above as it considers that they are necessary in order to address specific risks to investor protection that are not adequately addressed by the MiFID Directive and Implementing Directive and these risks are considered to be of particular importance in the circumstances of the market structure of the State.

⁴ The client classification will be updated to reflect the MiFID regime.