Justification for Retention under Article 16(2) of 2006/73/EC

MiFID Client Money – Additional Rules to ensure client assets are separately identifiable and to safeguard client rights and prevent the use of client assets by the firm for its own use.

CMR not covered by the MiFID provisions

Requirements dealing with the Registration of Client Financial Instruments

It is noted that under Article 16(1)(d) of the Implementing Directive firms must "*take the necessary steps to ensure that any client financial instruments deposited with a third party are separately identifiable from the financial instruments belonging to the investment firm and from financial instruments belonging to that third party, by means of different titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection*".

Additionally Article 16(2) states that "*If, for reasons of the applicable law, including in particular the law relating to property or insolvency, the arrangements made by investment firms in compliance with paragraph 1 to safeguard clients' rights are not sufficient to satisfy the requirements of Article 13(7) and (8) of Directive 2004/39/EC Member States shall prescribe the measures that investment firms must take in order to comply with those obligations*," where Article 13(7) and (8) of the MiFID require that an investment firm shall when holding investment instruments and funds belonging to clients make adequate arrangements to safeguard the clients' rights and prevent the use of client funds for its own account[1].

Therefore as certain of the Client Money Rules currently issued by the Irish Financial Regulator under Section 52 of the Investment Intermediaries Act, 1995[2] (the Client Money Rules – "CMR") are necessary, in the light of jurisprudence arising from recent insolvencies, in order to safeguard clients' rights and to prevent the use of client funds for the firm's own account it is considered that they may be maintained under Article 16(1)(d) and Article 16(2) and a separate notification to the Commission under Article 4 of the MiFID Implementing Directive is not necessarily required.

It is considered that the following CMR relating to the registration of client financial instruments could fall either within the "other equivalent measures" provided for in Article 16(1)(d) or the measures that the Irish Financial Regulator shall prescribe under Article 16(2) in order to safeguard clients' rights and to prevent the use of client funds for the firm's own account. Each current rule is followed by a justification for retention.

[1] An exception is provided for in the case of credit institutions whereby client funds (but not client investment instruments) may be used for own account.
[2] The Investment Intermediaries Act, 1995 transposes the provisions of the Investment Services Directive 93/22/EEC into Irish law.

Segregation (Current CMR - 2)

A firm must notify a client where it proposes to pool that client's money or investment instruments with those of one or more clients and, in the case of private clients, clearly explain the meaning and implications of pooling. Each private client must consent, in writing, to the holding of his/her money or investment instruments in such a manner. The consents, and disclosures referred to in this requirement and elsewhere in the Client Money Requirements shall be obtained and made before providing the first service either in the terms of business or investment management agreement as appropriate.

A firm should only pool a private client's money or investment instruments in the absence of the necessary consent where it can demonstrate that it has made every effort to procure such consent prior to the pooling of that client's money or investment instruments and has issued its standard notification stating that the notification will apply to the client relationship unless the firm hears to the contrary.

A firm must not use for the account of one client the assets of another client except where such use is in accordance with a legally enforceable agreement such as a set-off agreement or a securities lending arrangement.

The following criteria must be fulfilled[3] where it is sought to apply *a set-off* for the purpose of a *client money* calculation:

A. *Three Party Set-off*

(a) The *three party set-off* must:

(i) be agreed in writing between the set-off client creditor and the firm and enforceable by the firm without notice to the set-off client creditor or any other action;

(ii) be supported by a guarantee/indemnity from the set-off client creditor (as primary obligor) to the firm in respect of the obligations of the set-off client debtor to the firm in respect of which the set-off is sought to be effected; and

(iii) effect a *set-off* between the obligations of the set-off client creditor to the firm under the guarantee/indemnity and the obligations of the firm to *the set-off client creditor* in respect of any credit balance on its account with the firm.

(b) The guarantee/indemnity referred to in (a)(ii) must be executed as a deed.

B. *Bilateral Set-Off*

The bilateral set-off must be adequately documented and enforceable by the firm without notice to the client or any other action.

C. All *Set-Offs*

(a) Each set-off effected[4] must be written up in the ledger accounts of the set-off client(s) on the date on which it is effected.

(b) The firm must maintain, in accordance with the Books and Records Requirements issued by the Financial Services Regulator under Section 27 of the Stock Exchange Act, 1995 and Section 19 of the Investment Intermediaries Act, 1995 all documents relating to the arrangements.

---

[3] In the case of three party set-off the criteria must be fulfilled regardless of the nature of, or relationship between, the set-off client creditor and the set-off client debtor. This includes where the set-off client creditor and the set-off client debtor are married or related or are a natural person and a body corporate in which the natural person has an interest of any kind.

[4] This includes where it is treated as effected for the purposes of any client money reconciliation.

(c) The firm must ensure that:

(i) the set-off client creditor in the case of the three party set-off and the relevant client in the case of bilateral set-off (the creditor) has the required capacity and authority to enter into the arrangements;

(ii) all documentation relating to the arrangements is duly executed on behalf of the creditor;

(iii) where the creditor is a body corporate, there is (if required under applicable law) corporate benefit accruing to it from the arrangements;

and where necessary should obtain an opinion or opinions from its legal advisers on the issues set out at Requirements 2.6(c) (i) and (ii).

(d) The firm must obtain an opinion or opinions from its legal advisers that the arrangements are legally well-founded in all relevant jurisdictions and would be enforceable in all circumstances including, without limitation, any default of the set-off client(s) and any insolvency, bankruptcy, liquidation, reorganisation, moratorium, examinership of the set-off client creditor, the set-off client(s) or the firm.

(e) The Financial Services Regulator expects that all opinions referred to above will be provided by independent external sources of advice of appropriate professional standing. The Financial Services Regulator may, at any time require that such advisers provide a confirmation to it that in the case of three party set-off the criteria set out at A (a) and (b), and C (c) (i) and (ii) and (d) have been complied with and in the case of bilateral set-off that the criteria set out at B and C(c)(i) and (ii) and (d) have been complied with. The Financial Services Regulator may also require copies of the relevant opinions and/or the documentation relating to the arrangements.

Justification for Retention

<u>Pooling –</u> It is noted that under Article 32(3) of the MiFID Implementing Directive dealing with Operating Conditions for Investment Firms and the Information Requirements concerning Safeguarding of Client Financial Instruments and Client Funds "where financial instruments of a retail client or potential retail client may, if permitted by national law, be held in an omnibus account by a third party, the investment firm shall inform the client of this fact and shall provide a prominent warning of the resulting risks." However no requirement exists that a firm must obtain the client's explicit request to the client's financial instruments to be held in this manner. The Irish Financial Regulator considers that in the interests of the protection of all parties involved an explicit consent is required as it ensures that both the firm and the client are fully informed as to the manner in which the assets are held. Additionally provided that strict accounting segregation is maintained no difficulty should arise at any time in ascertaining the ownership of the financial instruments held in the account.

<u>Set Offs</u> - The rules outlined above are considered necessary as they are required to ring fence the funds held by the firm on behalf of the client in the client's bank account and to preserve these funds for client creditors. The use of set off agreements to reduce or clear the debit balances on client accounts must only be allowed where such agreements have been properly authorised between the client and the firm. The use of set off agreements that have not been so authorised to

reduce the amount by which a firm would be required to deposit its own funds in a client account in order to make up a deficit on a client account should not be permitted as it is considered to reduce the protection that should be provided to client creditors. It should be noted that this was a key conclusion in a High Court Judgement (given by Miss Justice Laffoy) regarding the liquidation of Money Markets International Limited where the use of an unauthorised set off is equated to a failure by the investment firm to adequately make up a deficit on the client money bank account at the relevant time. Under this judgement this inadequacy was to be borne by all client creditors and not just that creditor in respect of which the error arose further highlighting the requirement that the use of any set off agreement be adequately authorised in advance in order to ensure adequate protection of all client creditors.

When Assets Cease to be Client Assets (Current CMR – 7.1)

A firm must arrange for the prompt registration of a client's registrable client investment instruments in the name of the client, except in the circumstances outlined in Requirement 17.1[5].

Justification for Retention

This requirement is clearly necessary in order to ensure that client financial instruments are separately identifiable from those belonging to the firm or any third party with whom they are deposited.

Safe-keeping of Client Investment Instruments (Current CMR - 15)

A firm must hold any documents of title to client investment instruments in the case of both registered and bearer investment instruments:

a) in the physical possession of the firm; or
b) with a relevant party or an eligible custodian in a safe custody account designated as a client account. In such cases the firm must arrange for the lodgement of client investment instruments within one business day.

A firm must ensure that where it holds any documents of title the physical arrangements are appropriate to the value and risk of the investment instruments entrusted to it for safe-keeping and include adequate controls designed to safeguard them from damage, misappropriation or other loss.

A firm must instruct the eligible custodian to hold the firm's bearer investment instruments separately from clients' bearer investment instruments.

Justification for Retention

Although not explicitly stated in articles of the MiFID Implementing Directive dealing with the safeguarding of client assets this rule is necessary in order to ensure the protection of client investment instruments, to ensure client assets are separately identifiable and to safeguard clients' property rights.

[5] Requirement 17.1 is detailed below and refers to the registration of client investment instruments with an eligible nominee or a eligible custodian where it is not possible for legal reasons to hold the client assets in another manner.

Client Agreements (Current CMR - 16)

Before a firm provides safekeeping of asset facilities to, or receives collateral from clients, it must notify the client in writing (for example in its terms of business) of the arrangements applying in respect of:

a) Registration of client investment instruments and collateral if these will not be registered in the client's name;

b) Claiming and receiving dividends, interest payments and other rights accruing to the client;

c) Exercising conversion and subscription rights;

d) Dealing with take-overs, other offers of capital re-organisations;

e) Exercising voting rights; and

f) The extent of the firm's liability in the event of a default of an eligible credit institution, relevant party or eligible custodian.

A firm must obtain a client's prior written consent:

a) to the arrangements for the giving and receiving of instruction by, or on behalf of, the client and any limitations to that authority, in respect of the provision of safe-keeping services which it provides; and

b) before granting to any third party any lien or security interests over that client's investment instruments.

Justification for Retention

Although it is noted that under Article 32(6) of the Implementing Directive dealing with Operating Conditions for Investment Firms and the Information Requirements concerning Safeguarding of Client Financial Instruments and Client Funds "an investment firm shall inform the client about the existence and the terms of any security interest or lien which the firm has or may have over the client's financial instruments or funds, or any right of set-off it holds in relation to those instruments or funds. Where applicable it shall also inform the client of the fact that a depository may have a security interest or lien over, or right of set-off in relation to those instruments or funds" the requirement to notify the client in writing of the arrangements specified above are necessary in order to ensure the protection of both the client and the firm. Additionally although notification to the client of the existence and terms of any security interest or lien which the firm or a depository may have over the client's financial instruments provides a certain level of protection to the client the requirement to obtain the client's explicit prior consent ensures that the firm is adequately informed of the client's acceptance of these arrangements and therefore both the client and the firm achieve a higher level of protection.

Registration and Recording of Client Investment Instruments (Current CMR - 17)

A firm must arrange for the registration of registrable client investment instruments in the name of the client, unless the client has given prior written consent for the registration of these investment instruments in the name of:

a) an eligible nominee which is –
   (i) an individual, nominated in writing by the client, who is not a connected party of the firm; or
   (ii) a nominee company wholly owned by the firm ; or
   (iii) a nominee company wholly owned by an exchange which is a regulated market; or
   (iv) a nominee company wholly owned by a relevant party or eligible custodian; or

b) an eligible custodian or relevant party but only where due to the nature of the law or market practice of the jurisdiction outside Ireland, it is in the client's best interests or it is not feasible to do otherwise, and the firm has previously notified the client in writing that his investment instruments will be so held.

Justification for Retention

The Irish Financial Regulator is required to ensure that procedures in place in relation to the holding of client investment instruments are such that clients' rights are safeguarded and client investment instruments cannot be used for the firm's own account. Therefore it is considered necessary that the firm arrange for the prompt registration of registrable client investment instruments in the name of the client unless the client has expressly given his/her consent for the registration of those instruments in the name of an eligible nominee. In this regard the express request for the client's consent ensures the maximum level of protection for both the firm and the client as both are fully aware of the manner in which assets are held. Additionally the firm is required to ensure that any bearer investment instruments belonging to clients are held separately from those bearer instruments that belong to the firm.

Conclusion

The Irish Financial Regulator considers that the CMR detailed above, relating to the property of investment instruments and the separation of client investment instruments from those of the firm or any third party with whom they are held, are necessary in order to ensure that adequate arrangements are in place in order to safeguard clients' rights and to prevent the use of client funds for the firm's own account. Although explicit notification to the Commission is not required in respect of the Irish Financial Regulator's intention to maintain these CMRs details have been provided for completeness.