REVIEW OF THE REGULATORY REGIME FOR THE SAFEGUARDING OF CLIENT ASSETS

To the Deputy Governor, Financial Regulation

We are pleased to present a report with recommendations on the outcome of our review of the regulatory regime for the safeguarding of client assets.

We have been greatly assisted in this review by Colette Drinan and Fiona Lehane of the Central Bank and Donncha Connolly, formerly of the Central Bank. We have benefited significantly from the contributions of the other members of our task force from the supervisory, risk and policy divisions and members of the Central Bank staff from ISPS, MSSD, FASD, GAAP, CPC, Enforcement and Legal. We would like to acknowledge the assistance given to us by the CASS team at the FSA, the ICCL, various selected representative firms of the investment business community, Barry Cahir of William Fry and the members of the auditing firms and IAASA who attended a roundtable discussion.

Andrea Pack **James Bagge**

Cc Ms Blanaid Clarke
Chairperson of the Audit Committee

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EXECUTIVE SUMMARY

Background: Terms of Reference and Approach (Section 2)

1.1. In August 2011, the Central Bank commissioned a task force to review the regulatory regime for the safeguarding of client assets. The task force has been co-chaired by Andrea Pack and James Bagge, both risk advisors at the Central Bank.

1.2. There were a number of drivers for a review: the roll out in 2012 of the Central Bank's new supervisory risk model 'Probability Risk and Impact SysteM' (PRISM); experience of case studies both in Ireland and elsewhere where client asset issues have arisen; pending changes to European directives; and feedback from industry that the current rules for the safeguarding of assets should be reviewed.

1.3. The Terms of Reference charge us with reviewing and making recommendations on the scope of the regime, the adequacy of the Central Bank's supervisory arrangements, current arrangements for independent audits and potential use of 'skilled persons', and the impact any changes to European directives may have on safeguards.

1.4. We have had regard to the operation of the rules and regulations in place leading up to the appointment of Court Inspectors in relation to Custom House Capital Ltd (CHC) in July 2011.

1.5. At the outset, our approach was to identify and define what the objectives of the client asset regime should be with a view to assessing whether the current arrangements achieve these objectives; and where deficiencies were identified to make recommendations for improvement.

1.6. As part of this process, we reviewed the legislative framework and regulatory structure and assessed the effectiveness of the supervisory approach. We have been greatly assisted by discussions with internal and external stakeholders. The UK Financial Services Authority (FSA) has undertaken a substantive review of arrangements for the safeguarding of client assets and we have had close regard to changes in the UK where they may be relevant to the Irish market.

1.7. Our report is in six main sections:

- The Objectives of the Regime (Section 3);
- Custom House Capital Ltd (Section 4);
- The Legislative Framework (Section 5);
- The Client Asset Requirements (CAR) (Section 6);
- The Regulatory Structure (Section 7);
- The Supervisory Approach and Use of Enforcement (Section 8)

Section 9 contains a summary of recommendations and Section 10 concludes with suggestions as to next steps.

The Objectives of the Regime (Section 3)

1.8. It is clearly the responsibility of the firm and its senior management to ensure client assets are protected. Legal and regulatory regimes provide a framework for so doing and act as a deterrent to misuse of those assets.

1.9. However regulation is only ever able to mitigate the risk and can never eradicate it. For a number of reasons, firms can and will fail. The fallout from the financial crisis has also highlighted a number of important issues as to ownership and entitlement. The resolution of such issues and the difficulties insolvency practitioners may experience in understanding a firm's arrangements and records add to the costs of the insolvency and hinder the expeditious return of client assets to the owner. Thus public confidence in the regime can be undermined.

1.10. We recommend the following three objectives should form the foundation of any client asset protection regime:

- The maintenance of public confidence in the client assets regime;
- The mitigation of the risk of misuse of client assets whether as a result of maladministration or fraud; and
- The provision of a system which in the event of a firm's insolvency will enable the expeditious return of available client assets to the owner at lowest cost.

It is against these objectives that we assess the effectiveness of the present arrangements.

Custom House Capital Ltd (CHC) (Section 4)

1.11. Our assessment relies predominantly on the report of the Court Inspectors and earlier Central Bank inspection reports.

1.12. The findings were wide ranging including CHC acting outside clients' mandates, improper transfers of funds particularly into property vehicles, false valuation statements to clients and significant breaches of the client asset regulations. None of these concerns were identified in the regular reports by the external auditors.

1.13. There were also conduct of business issues with added uncertainties and complexities created by the mix of regulated and unregulated activities. It was difficult for the Central Bank to form an holistic view of the position at an early stage as separate divisions were involved; and each area tended to focus on discrete rules and breaches within their own areas of responsibility. Had a more comprehensive view been possible, the regulatory response may have been different.

1.14. The Central Bank was losing confidence in the firm's senior management to address the issues. It would have preferred to change CHC's senior management but lacked the power to do so short of revoking the authorisation which was judged as likely to result in greater potential loss to customers; similarly, the other option of liquidation.

1.15. The Central Bank was therefore unable to intervene effectively in the management of the business and was hindered by the absence of the ability to appoint an Administrator.

The Legislative Framework (Section 5)

1.16. Section 5 explains the framework in some detail, identifies areas where primary legislation could be revised to achieve our recommended objectives, and reports on forthcoming EU developments.

1.17. Experience suggests that when firms get into difficulties, the risk to client assets increases significantly and regulatory intervention at an early stage would help to protect those assets. As noted in the case of CHC, the Central Bank has no powers to intervene directly in the management of a firm's business short of withdrawing its authorisation or having it wound up. These draconian measures may not be in the interests of clients and measures such as appointment of Court Inspectors are reactive and may be too late.

1.18. The Central Bank should be able to take speedy, proactive action where there are serious problems of a financial nature and/or the interests of clients are at risk. We recommend the Central Bank be given the power to apply to the Court for the appointment of an Administrator or a person with equivalent powers.

1.19. The economic climate remains unpredictable where insolvencies can occur with little notice. Past experience shows that the Client Assets Requirements (CAR) regime and insolvency provisions should complement each other more effectively. We recommend that urgent consideration is given to revising the existing insolvency provisions in line with the pre-determined distribution rules proposed by the Investor Compensation Company Limited (ICCL) and that such revisions take account of developments elsewhere, in particular, the UK's Special Administration Regime for investment firms.

1.20. Proposed and revised EU Directives are not in final form. However, information to date suggests that safeguards we are recommending to improve effectiveness of the regime are unlikely to be adversely impacted by forthcoming changes. It should be noted that the Investor Compensation Directive (ICD) has a proposal to increase significantly the level of investor protection well above the current minimum €20,000.

The Client Asset Requirements (CAR) (Section 6)

1.21. In May 2011, the Central Bank conducted a review of firms' views on the CAR. Their comments and our subsequent engagement with stakeholders indicate that the CAR needs a revision with issues as to form, scope and substance. There are inconsistencies in interpretation and application. Firms' senior management and others who are not working with the requirements routinely have difficulty in understanding the rationale for the content of some of the requirements.

1.22. We recommend that the presentation of the CAR be revised to facilitate more effective compliance by:

(a) Making greater use of higher level principles reinforced with guidance so as to introduce greater flexibility into the regime and a more accessible explanation of the rationale of the rules; and

(b) Avoiding unnecessary and potentially contradictory statements.

1.23. Other recommendations include:

- For authorised firms, a wider definition of client funds should be adopted consistently so that monies received and held on behalf of clients are subject to the CAR, regardless of the intended investment of these monies (i.e. even if intended to invest these monies in unregulated products);
- A practicable and relevant regime, which draws on best practice, should be developed specific to the operation of subscription and redemption accounts (DDA accounts). This should be progressed in consultation with the Financial Service Providers in the Collective Investment Scheme sector;
- A revised CAR providing for sensible and practical application of the rules with respect to daily calculations, the formula used to calculate the buffer, reconciliations, and terminology for the designation of client accounts; and
- A revised CAR, which sets out clearly conduct of business provisions.

1.24. To facilitate a revised and improved CAR, we recommend a joint Central Bank and industry group be established to develop detailed proposals.

The Regulatory Structure (Section 7)

1.25. We consider the features of the regulatory structure, in addition to CAR, against which applicant and authorised firms are assessed and supervised.

Authorisation

1.26. Through its gatekeeper role, the authorisation process should ensure that only firms able to meet appropriate standards are authorised to hold client assets. Our examination of current processes indicates that an application to hold client assets does not necessarily trigger consideration of a more onerous assessment and/or requirements.

1.27. Applications by firms to hold client assets should be considered more holistically, using risk-based techniques so that the range of the applicant's activities and its governance and processes can be fully assessed.

Pre-approved controlled function (PCF)

1.28. It is evident from the Central Bank's and other regulators' experience that where client asset issues have arisen it can be difficult to establish responsibilities. Different parts of the firm

are involved and matters may be left to compliance personnel, who may not have the depth of skills and experience required. This is unsatisfactory.

1.29. We recommend a Client Asset PCF is introduced for all firms holding or intending to hold client assets. This person would normally be a director of the firm. For the largest firms, a director may not be practical in which case a member of senior management may fill the role.

Client Asset Management Plan (CAMP)

1.30. A firm's business model and arrangements for the safeguarding of client assets rarely are set out in one document. Without such a plan, senior management may not have a full understanding of the arrangements, requirements, risks and mitigants in their firm. Supervisory and external reviews may be impeded as would the work of an insolvency practitioner in the event of a liquidation. We recommend that a document, CAMP, be required for all firms subject to CAR. The firm's governing body should sign off the CAMP and the Client Asset PCF should be responsible to the board in assessing the firm's compliance with it.

The Supervisory Approach and Use of Enforcement (Section 8)

1.31. The supervisory approach involves a variety of divisions and a mix of tools: meetings with firms, financial returns, inspections by Central Bank staff, CAR reports by external auditors; external commissioned reviews and in the future, the potential for greater use of 'skilled persons'.

1.32. PRISM sets the minimum level of resource to be applied to firms in different impact categories. We believe that assurance as to the safeguarding of client assets requires an assessment of risk above and beyond the differentiation within PRISM. Our observations on the present arrangements lead us to recommend a suite of measures to provide more effective supervision in future. In so doing, we recognise that these measures have implications for resources which are above those set under PRISM.

1.33. The present arrangements do not facilitate a consistent supervisory approach and are not best organised to ensure a comprehensive assessment of risks to client assets within and across firms; and timely, consistent regulatory responses. In their daily work, supervisors and inspection teams have responsibilities other than client assets which may result in client asset issues not being sufficiently prioritised.

1.34. The CAR reports by external auditors should give comfort to the firm and regulator that client assets are being safeguarded appropriately. While there is value in the discipline an independent review places on firms, experience shows that they provide little added value and do not complement the work of the Central Bank's inspection teams.

1.35. Enforcement is an important deterrent but few cases have been referred and/or come to fruition. Resources in Enforcement have been enhanced recently and mechanisms established for improved communications between supervisors and Enforcement.

1.36. We believe that internal and external resources could be deployed more effectively to deliver the objectives. Our key recommendations are:

- The establishment of a Client Asset Specialist Team (CAST) with cross–sectoral ownership of client asset risk;
- CAST should use the opportunities presented by PRISM to operate a risk–based approach with pre-determined triggers for intervention;
- The establishment of a senior management committee – Client Asset Review Committee (CARC) – chaired by the Deputy Governor (Financial Regulation) to which serious matters could be referred within a matter of hours;
- Standing quarterly meetings of CARC to review sectoral client asset risk maps;
- A revised approach to external audit reports which would be replaced by an annual Client Asset Examination (CAE) using a firm's CAMP as the starting point for review combined with spot checks during the period;
- Regular communication between the Central Bank and auditors to discuss CAEs;
- The use of 'skilled persons' to report on complex issues or in response to certain trigger events;
- Greater use of industry dialogue as a tool to update on best practice and emerging issues – CAST would be well placed to do this; and
- CAST with its specialist knowledge should liaise regularly with Enforcement to increase the flow of referrals and successful outcomes.

Suggestions as to Next Steps (Section 10)

1.37. We suggest that responsibility for implementing recommendations should lie with the Deputy Governor (Financial Regulation) and that an implementation plan and timetable be established. Recommendations relating to internal arrangements could be adopted quickly; others require dialogue and consultation which it would be advisable to initiate as soon as possible. It may be desirable to commission an internal audit review of the changes in operation a year or so after implementation.

TERMS OF REFERENCE AND APPROACH

2.1. The Central Bank of Ireland (the Central Bank) established a task force, "the Client Asset Task Force" to review the scope of the regulatory regime as regards the safeguarding of client assets, and the current arrangements it operates to supervise how regulated financial service providers (firms) receive and hold client funds and financial instruments. The task force has been co-chaired by Andrea Pack and James Bagge, both risk advisors to the Central Bank; supported by other members of the task force drawn from the relevant divisions in the Central Bank that supervise firms holding client assets, the Central Bank's Risk Division and its Governance, Auditing and Accounting Policy Division.

2.2. The review is timely due to a number of coinciding events. Firstly, the Central Bank is in the process of rolling out its new supervisory risk model PRISM and it is important to consider how client asset supervision should dovetail with that model. Secondly, the Central Bank considers it appropriate to take stock of how the approach to client asset supervision is working against actual case studies both in Ireland and elsewhere where client assets have not been properly safeguarded by regulated firms, including events leading to the appointment of Court Inspectors at CHC. Thirdly, there are pending legislative changes to MiFID[1], AIFMD[2] and UCITS[3] which may impact the client asset regime. Finally the Central Bank has recently engaged with industry to seek its views on the existing client asset requirements and the feedback from this suggests that a broader review is necessary.

2.3. The Terms of Reference for the task force charged it with reviewing and making recommendations in relation to the following key areas:

- The scope of the regulatory regime as regards safeguarding client assets by reference to (i) asset types, (ii) investment activities and (iii) types of firms;
- The adequacy of the Central Bank's supervisory arrangements for the safeguarding of client assets including linkages to the arrangements for supervision of Conduct of Business rules;
- The adequacy and implementation of current guidelines for independent audits of client assets and the potential for the use of "skilled persons" reports to supplement these audits; and
- The sufficiency of the current rules and regulations that are in place for client asset protection taking account of the forthcoming changes to MiFID and the UCITS directives.

The full Terms of Reference are set out in Appendix I.

2.4. In addressing these Terms of Reference the task force determined to identify and define at the outset what the commonly agreed objectives should be of the client asset regime with a view to assessing the extent to which the current regime achieves those objectives (**Section 3).** Pursuant to our Terms of Reference we had regard to the events leading to the appointment of Inspectors at CHC and the lessons to be learnt therefrom **(Section 4).** As

[1] Markets in Financial Instruments Directive (MiFID)
[2] Alternative Investment Fund Managers Directive (AIFMD)
[3] Undertakings in Collective Investment in Transferable Securities (UCITS)

part of this process we have examined the legislative and regulatory framework which currently defines the CAR regime **(Sections 5, 6 and 7).** We have looked at the supervisory arrangements in place throughout the Central Bank for various types of firms that hold client assets; and we have reviewed how these arrangements are being applied in practice, how firms themselves are responding to the requirements and we have sought to identify how those processes can be better arranged to achieve greater effectiveness **(Section 8).** The UK has undertaken a substantive review of its arrangements for client asset regulation and we have had close regard to their approach to garner what lessons can be learnt for the Irish market. Our recommendations on how the CAR regime can be enhanced are summarised **(Section 9)** and we suggest next steps in the final section **(Section 10)**.

THE OBJECTIVES OF THE REGIME

3.1. The principal requirements defining the regime, the CAR[4], which apply not only to MiFID firms but also to those authorised under section 52 of the IIA[5], require firms (a) when holding financial instruments belonging to clients *"to make adequate arrangements to safeguard clients' ownership rights, especially in the event of the firm's insolvency and to prevent the use of a client's instruments on own account, except with the client's express permission"* and (b) when holding funds (monies) belonging to clients *"to make adequate arrangements to safeguard the client's rights and, except in the case of credit institutions, prevent the use of client funds for the firm's own account"*. The emphasis in respect of both instruments and monies is on the safeguarding of clients' ownership rights (note not the inherent value of those assets) so as to avoid the risk of exposure to non-client third party claims in the event of a firm's insolvency or the risk of the use by the firm in the course of its business of those clients' assets without express permission.

3.2. These risks are real. The fall-out from the financial crisis has given rise to a number of examples domestically and internationally of client assets being exposed to dispute as to ownership and entitlement and resultant losses. Lessons are being learned in other jurisdictions as to the effectiveness of client asset safeguard regimes.

3.3. Taking steps to ensure that a firm does not use client assets for the conduct of its own business is an essential feature of safeguarding client assets from the risk inherent in mixing the firm's assets with those of its client. Ultimately this is the responsibility of the firm and its senior management. More than that, safeguard regimes are of course an inhibition to any misuse or misappropriation of those assets by the firm, whether inadvertent or deliberate. But it is important that the limitations of any such regime are recognised, specifically that regulation is only ever able to mitigate the risk of such an occurrence and can never eradicate it.

3.4. A common theme which has developed in discussion in particular with the FSA, but is also evident from US processes, is the desirability not only of safeguarding the client assets but also, in an insolvency, of being able to return those assets to clients as efficiently and cost effectively as possible. We think that this too should be an acknowledged objective of any CAR regime as it tends to impact on the design of any solution.

3.5. Finally a fundamental principle of any financial services regulatory regime has to be the maintenance of public confidence in the system. An essential part of this is the confidence in knowing that one's ownership rights in any monies or investment entrusted to authorised entities are well protected. To identify this as an objective of the CAR regime is arguably just a restatement of the wider objectives of the entire regulatory structure. But there are elements involved in the maintenance of public confidence which are particularly relevant to the CAR regime and important to acknowledge. Clients' expectations as to the regime need to be managed. For example, clients need to know that it is their ownership rights only which are being safeguarded and not the value of their investments. They need to know

[4] Client Asset Requirements issued under S.I. No.60 of 2007 European Communities (Markets in Financial Instruments) Regulations 2007

[5] The Investment Intermediaries Act, 1995

when they are operating within the protective shield of regulation and when they are not. They need to appreciate that there will be stages in the investment process perhaps when their assets may be more at risk than at others, for example the use of common pools during subscriptions and redemption processes associated with investment in funds.

3.6. **We therefore recommend, having regard to the Central Bank's high level goals in respect of financial regulation[6], three principal objectives which we would suggest should form the foundation of any client asset protection regime:**

- **The maintenance of public confidence in the CAR regime;**
- **The mitigation of the risk of misuse of client assets whether as a result of maladministration or fraud; and**
- **The provision of a system which in the event of a firm's insolvency will enable the expeditious return of available client assets to the owner at lowest cost.**

[6] These include: 'Ensure proper and effective regulation of financial institutions and markets' and 'Ensure that the best interests of consumers of financial services are protected.'

CUSTOM HOUSE CAPITAL LIMITED (CHC)

4.1. Under its Terms of Reference, the task force is required to have regard to the operation of the rules and regulations in place to safeguard client assets in the events leading up to the appointment of Court Inspectors ("the Inspectors") in relation to CHC. For these purposes we have relied predominantly on the facts of the case as stated in the report of the Inspectors. We have also had access to the earlier Central Bank inspection reports and have spoken with the supervisors who managed the case post 2009.

4.2. CHC has been authorised in Ireland since January 1998 and is currently authorised as a MiFID investment firm under the MiFID Regulations. CHC provided the services of discretionary investment management, the setting up and management of Approved Retirement Funds (ARFs)[7], pension funds and non-standard Personal Retirement Savings Accounts (PRSAs)[8]. Its customers were mainly high net worth individuals based in Ireland. Client investments are held in the form of qualifying investor funds (QIFs), exempt unit trusts[9], shares in property (SPVs) and direct holdings in equities, debt instruments and cash. As at the date of publication of the Inspectors' report CHC managed over €1.155 billion worth of assets on behalf of its clients. CHC acquired in excess of 70 large commercial properties across Europe on behalf of investors.

4.3. On 15 July 2011 the Central Bank applied to the High Court for orders authorising an investigation into the affairs of CHC and also the appointment of Inspectors to undertake this investigation arising from serious concerns that the Central Bank had in relation to the safety of client assets held with CHC.

4.4. In their final report dated 19 October 2011, the Inspectors found that there was a practice of CHC effecting transactions on behalf of clients in a manner which could not have been envisaged by those customers and for which no mandate or authorisation had been given by those clients. The Inspectors have identified approximately €56 million of client "holdings"[10] that were improperly transferred; the majority of these were transferred to syndicated property investments. These client assets were taken from a variety of investment structures managed by CHC, only some of which were subject to regulation by the Central Bank and therefore subject to the CAR.

4.5. A greater part of these misappropriated assets (€37 million) was held in an exempt unit trust structure ("the EUT") otherwise referred to as the Destiny product. CHC was the investment manager to cash and equity funds held within the EUT. CHC in effect changed the investment mandate of the equity and cash funds and invested 76% and 95% respectively in property transactions. EUTs are not subject to regulation and none of the assets placed therein are subject to the CAR.

[7] An ARF is a post retirement investment fund into which certain retirees can invest their pension savings. Capital gains and investment income are not taxed when retained within the fund. Tax is only applied on withdrawal.

[8] A PRSA is a type of personal pension contract introduced in 2003. It is a contract between an individual and an authorised PRSA provider. It is a defined contribution plan. A non-standard PRSA is a contract that does not have maximum limits on charges and/or allows investments in funds other than pooled funds.

[9] An exempt unit trust is a collective investment scheme which is exempt from tax on its income and gains. The trust deed for each trust limits investment to investors who have approved revenue status such as a pension fund or charity. Exempt unit trusts do not fall within the scope of the Unit Trust Act, 1990 as they are not considered to provide facilities for participation by the public and are therefore not subject to authorisation or supervision by the Central Bank.

[10] The Inspectors' term

4.6. CHC also operated various client accounts, holding both investments and cash belonging to clients. Some of these accounts had discretionary mandates conferring asset management discretion on CHC, but many did not. Cash was held with CHC within segregated and pooled designated client accounts. However the Inspectors found that cash (€11.9 million) from one or more of these accounts was improperly taken and used to fund CHC promoted client property developments. Valuation statements issued to clients were falsified.

4.7. Clients invested a net €5.5 million in three protected capital bonds which were reportedly redeemed in 2009 for approximately €7.6 million. This cash was then placed with a German bank as collateral for a loan to fund certain property investments.

4.8. Client funds were also invested in a Mezzanine Bond Fund ("the MBF") used by CHC to finance property investments and in respect of which they offered guarantees up to 100% of the investors' funds plus a fixed return of 5-7% per annum. It was in respect of these investments and specifically on receipt of information in March 2009 that they were being arranged without the clients' knowledge or consent that the Central Bank started to take action. It instigated an immediate inspection, following which it commissioned reviews by two major independent professional services firms. The Central Bank issued a series of directions as to the further handling of these assets and to enhance the corporate governance arrangements.

4.9. CHC had also established a property fund ("CHC Property") which was authorised by the Central Bank in 2006 as a qualifying investor designated investment company, which is a non-UCITS collective investment scheme ("CIS") [11] and, for client asset protection purposes, subject to regulation under the non-UCITS Series of Notices.[12] (The CAR do not apply to collective investment schemes). These regulations stipulate that client assets held in such a scheme are to be entrusted to a trustee firm for safe-keeping. In the case of CHC Property, the appointed trustee firm is Bank of America Custodial Services Ireland Limited ("Bank of America"). CHC received €55.5 million and €30.4 million in subscription monies into two separate sub-funds ("CHC1" and "CHC2") between September 2008 and January 2009 and December 2009 and July 2010 respectively[13]. Subscription monies received did not transfer to CHC Property or Bank of America as trustee but were used by CHC to purchase properties on behalf of investors. CHC1 was launched in the last quarter of 2009 by way of an in specie subscription of properties into the fund and the issue of shares to investors. As at the date of the Inspectors' report, custody matters as to some of these properties had still to be resolved. CHC2 was never launched; insofar as neither assets nor cash were ever transferred to the fund or the trustee and shares were never issued to investors.

4.10. CHC was inspected by the Central Bank in 2007 and in March 2009. A routine inspection in 2007 found significant breaches in the Client Money Regulations, as they were then known. These included the fact that no daily calculations were being performed; that clients were not being notified of the fact that their monies were being held in pooled accounts; that there were recurring un-reconciled items on the bank reconciliations which were not notified to

[11] Under the Unit Trusts Act, 1990 and Part XII of the Companies Act, 1990

[12] The non-UCITS Series of Notices impose statutory conditions on CIS. The conditions are set out in the non-UCITS Notices are imposed under the powers granted to the Central Bank by non-UCITS CIS legislation and have similar force in law.

[13] The subscription forms were received at these times by the administrator of the CIS (LaCrosse Global Fund Services).

the Central Bank, some of which were very significant including one for €4 million outstanding for more than one year[14]; that CHC did not record cheques as client money on receipt but rather on clearance; monthly reconciliations of investment instruments were not being performed and clients were not notified as to how their assets were being held. These findings were contained in a final inspection letter to which CHC responded formally in December 2007 setting out the actions taken to remedy these findings, and giving an assurance that a full time compliance officer would be appointed in early 2008. The point was also made in the inspection report that none of these issues had been reported by the auditors. CHC wrote again in February 2008 with an update on the remedial steps taken and enclosing a response from their auditors. Beyond receiving this assurance, we were told that the Central Bank would not customarily initiate any form of follow up review.

4.11. CHC was next inspected by the Investment Service Providers Supervision Division (ISPS)[15] of the Central Bank in March 2009 following the receipt of information about potential misappropriation of client assets in the MBF. The inspection itself took place over three days in the first week of March and was followed in April by a review undertaken by a major professional services firm focusing on four properties/funds representing 18.2% of the value of properties managed by CHC and included CHC1 (see paragraph 4.9). A report was issued in June 2009 and it identified a number of serious issues. In its covering letter, the Central Bank expressed concern with respect to:

- The MBF – that the firm had provided inaccurate and misleading information in relation to both the structure of the bond and the transactions financed from the proceeds of the bond;
- The Property funds - that the firm had purchased properties in late 2008 but as at June a significant amount of equity finance had still to be raised from investors;
- Financial information - that it remained unclear to the Central Bank how the firm was maintaining full compliance with the Large Exposure Provisions under the Capital Requirements Directive (CRD);
- Internal organisation and governance - specifically as to the need for the appointment of an independent non-executive director and improving its compliance resources;
- Back office, operations and organisational controls - noting inter alia the considerable delays experienced by the Central Bank in the receipt of information; the fact that the information provided was often inconsistent and conflicting; that there was no back office manager; that there was a lack of transparency across the property structures, client and firm bank accounts and that the firm operated an omnibus account for all property transactions; the absence of any timely or accurate communication of investment updates to clients and the failure to formalise and complete investor documentation for property transactions;
- CHC1 and CHC2 - that communications to investors implied that they had contributed to a regulated QIF but that the monthly submissions required as an authorised QIF indicated otherwise as the firm had registered a zero NAV implying the QIF held no assets and had issued no units; and

[14] The inspection team did investigate this further and were satisfied that they could trace the postings to relevant accounts. The differences they concluded had been due to late postings, a finding which with the benefit of hindsight was significant given the subsequent discovery of CHC management's method of concealment.
[15] ISPS is the Central Bank division responsible for the prudential supervision of CHC.

- The CAR - that there were breaches concerning the designation of client accounts; that in its calculation process the firm was including negative balances on the list of clients to whom it owed money and it was doing calculations on an individual account basis and not calculating a global funding position; and that its treatment of cheques in transit was wrong.[16]

4.12. Possible breaches of the Central Bank's conduct of business requirements identified with the MBF during the inspection led ISPS to contact Consumer Protection Codes Division (CPC) who also conducted an inspection starting on 12 March 2009. CPC reviewed a sample of 20 of the 180 clients that invested in the MBF. Each of these was checked to see if clients had given the firm discretion over their investments or that there was evidence of advice given. A majority of clients did not have a discretionary agreement in place nor was there evidence of advice being given in advance of the movement of the money. Nor was there any evidence of a fact find having taken place. The case was passed to the enforcement section that was located within the Consumer Directorate at that time. Eventually the case was transferred to the Enforcement Directorate.

4.13. The Central Bank did take significant and repeated steps during 2009 and 2010 to require the management to deal with all the issues arising from the inspection with an intense focus on the firm's cash flows, and corporate governance arrangements including the removal of the auditors who had never identified any breaches of CAR. In mid-2010 a point person was appointed to co-ordinate the Central Bank's strategy across the divisions. The main elements of the Central Bank's strategy during 2009 and 2010 were to understand better the firm's exposure to its property investments, force the firm to restore those monies due to the clients as and when they could be realised in an orderly way, i.e. avoiding forced sales of property, and to improve the very weak solvency position of the firm until such time as its business could be sold and management thereby replaced. While it was appreciated that CHC management presented a significant risk, the Central Bank's greater fear was that the removal of its authorisation and consequent abrupt cessation of business would cause even greater potential loss to the underlying customers. The other option, liquidation, would also have had the same potential outcome.

Lessons learned

4.14. It is clear with the benefit of hindsight and the information now available in the Court Inspectors' report that there were a number of relevant warning signals in the findings of both the inspection reports. By the middle of 2009 the Central Bank would have preferred, if it had had the power, to introduce new management to the business. Seeking to enhance the governance arrangements, as it did with the appointment of one non-executive director, proved unsatisfactory in the circumstances. The first lesson to be learned from the CHC case as regards the protection of client assets is that, where the Central Bank has lost confidence in the senior management of a firm and there are grounds to believe that client assets are at risk, the Central Bank must be able to apply to the court for the appointment of an Administrator.

4.15. The Central Bank's response in March 2009 seemed to be too rigid and inflexible to develop a more holistic view of what was going on at CHC. In the conduct of its business CHC drew

[16] Funds represented in cheques payable to clients do not cease to be client funds until the cheque is encashed.

no boundaries between regulated and unregulated products. The inspections focusing as they were designed to do on the regulated activities and products, failed to identify the bigger picture. Even when KPMG was commissioned to look at the operation of the MBF and parts of the property fund business, no separate steps were taken to look at the conduct of the business as a whole or to seek to rely on anything other than information generated by CHC itself. Conduct of business issues were identified which, with the benefit of hindsight, proved to be an essential part of whole misconduct, and yet these were passed to a separate division to be followed up. Separate divisions were involved and consulted. They focused on discrete rule breaches and activities of the firm particular to their own responsibilities. As a result, at least in the early stages, no co-ordinated and more discerning regulatory response resulted to piece together the bigger picture.

4.16. The mix of regulated and unregulated activities within one authorised business gave rise to real jurisdictional difficulties for the Central Bank and enhanced risk to the security of client assets, not least the uncertainty in part because of the lack of clarity within the requirements themselves, as to whether certain investments fell within the CAR regime or not. This enhanced risk needs to be recognised and managed in some way, whether by restricting the proportion of unregulated business an authorised entity can undertake or reflecting the risk in the capital adequacy requirements of the firm. At the same time and particularly where there is a mix of regulated and unregulated business, there appears to have been a lack of safeguards from a conduct of business perspective. The risk of clients being switched unwittingly in these businesses from the regulated to unregulated products needs also to be recognised and managed more closely by the firms at first instance and overseen by the Central Bank.

4.17. There appeared to be too great a dependence on reconciliations and confirmations by reference to the firm's own records, which it is now known were being falsified and oral assurances from its own management, whom it is known were responsible for a business where, in the words of Mr Justice Hogan, [17] 'The Inspector's findings make for grim and disturbing reading. They concluded in almost every respect that there had been systematic abuse of client funds for improper purposes and that this conduct was pervasive within CHC'. Ways should be explored of reconciling the firm's records with those of the banks or institutions with whom the assets are held and/or the underlying clients. If it is not possible to do this as a matter of routine, it should certainly be available where suspicions of misappropriations arise. KPMG reported that it was not able to trace investor funds on an individual basis to the relevant investments [18]. Whether the ultimate investment is a regulated or an unregulated product, we would contend that in an authorised business one should always be able to follow the trail from initial lodgement of the funds through to the ultimate investment.

4.18. Finally, the external CAR audits disclosed no evidence of the potential mis-use of client assets in the case of CHC. We deal in more detail with our thoughts on this subject in Section 8.

[17] Judgement delivered 28 October 2011 in the matter of Custom House Capital No 2

[18] The Court Inspectors engaged KPMG to assist them in their investigation into the affairs of CHC and their findings are included in the Court Inspectors report

THE LEGISLATIVE FRAMEWORK

Introduction

5.1. The regulatory regime operates within a legislative framework. We begin by explaining this framework, how it applies and to whom, and then identifying aspects of the broader regime defined by primary legislation which need to be reformed in order to achieve our recommended objectives. Finally we report on forthcoming EU developments which may have an impact on the regime.

Scope of the legislative framework

Investment Firms/Investment Business Firms

5.2. The current legislative structure that regulates receiving and holding client assets is complex. The main supervisory requirements that regulate the holding of client assets are the CAR, which are considered in detail in Section 6. The CAR are imposed under two pieces of legislation. They are imposed on all investment firms that hold client assets under Regulation 79 of the European Communities (Markets in Financial Instruments) Regulations 2007 (S.I. 60 of 2007)[19] (MiFID Regulations) and on all investment business firms that hold client assets under Section 52 of the IIA.

5.3. The MiFID Regulations define an investment firm by reference to the services provided in respect of defined financial instruments. Appendix II sets out these specific services and instruments.

5.4. The IIA defines an investment business firm as any person, with certain exceptions, who provides one or more investment business services or investment advice to third parties on a professional basis. The IIA preceded the MiFID Regulations. With the introduction of the MiFID Regulations in 2007, firms that met the definition of investment firms under MiFID were no longer subject to the IIA[20]. However the IIA remained in force for certain firms that fell within its scope but outside that of the MiFID Regulations – notably most fund administrators and non-credit institution trustees. Appendix III sets out the investment business services and instruments as defined in the IIA.

5.5. The CAR then applies to firms that meet the definition of an investment firm or an investment business firm as specifically defined either in MiFID or the IIA. As these definitions are based on a list of specific instruments it means that any investment products that are not on these two lists are not covered by the CAR. However firms are not precluded under legislation from providing services in these "unregulated products"; as a result certain activities of these regulated firms are subject to the CAR yet others are not.

[19] The European Communities (Markets in Financial Instruments) Regulations 2007 transpose the MiFID in Ireland.
[20] Regulation 6 of the MiFID Regulations

5.6. The concept of "holding client assets" is defined by law by the IIA[21] and incorporated in the CAR. Following the Morrogh working group report, control of client assets no longer fell within the scope of the CAR[22]. Rather such activity is subject to general supervisory requirements.

Fund Service Providers

5.7. Trustees (which are not credit institutions) and most administration companies, together known as Fund Service Providers (FSPs) are authorised under the IIA. Accordingly where they hold client assets they are subject to section 52 of the IIA and therefore subject to the CAR. The regulatory position relating to these companies is considered in more detail in Section 6.

5.8. Once money is invested in the CIS it no longer constitutes client money subject to the CAR. Under the UCITS and Non-UCITS Regulations set down by the Central Bank and imposed on authorised CISs the assets belong exclusively to the CIS and must be entrusted to a trustee for safe-keeping. The assets must be segregated from the assets of either the trustee or its agents or both and may not be used to discharge directly or indirectly liabilities or claims against any other undertaking or entity and shall not be available for any such purpose.

Payment Institutions

5.9. Payment institutions and electronic money institutions are also subject to client money regulations under Regulation 24 of the European Communities (Payment Services) Regulations 2009 (Payment Services Regulations) and Regulations 29 and 30 of the European Communities (Electronic Money) Regulations 2011 respectively. There are currently no e-money institutions in Ireland therefore the regulations for payment institutions (PSD Regulations) only are outlined in the next paragraph. There are eleven authorised payment institutions but only six in operation. Payment institutions are not subject to the CAR.

5.10. A payment institution receives cash in order to execute a payment on behalf of the user. This has to be safeguarded until the payment is actually completed. This is done in two ways as permitted by legislation:

a) the cash should be segregated from other users and deposited in a separate account or invested in secure, liquid and low-risk assets until paid; or
b) the funds should be insured.

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[21] An investment firm or investment business firm is deemed to hold client money where:

1. the money has been lodged on behalf of a client of the firm to an account with a credit institution or relevant party in the name of the firm or any nominee of the firm, and
2. the firm has the capacity to effect transactions on that account.

An investment firm or investment business firm is deemed to 'hold' client financial instruments where the firm:

1 has been entrusted by or on account of a client with those instruments; and
2 either
   (i) holds those instruments, including by way of holding documents of title to them, or
   (ii) entrusts those instruments to any nominee,

and the firm has the capacity to effect transactions in respect of those instruments.

[22] Background as to the reasons for this are set out in the final report of the Morrogh working group.

The insurance approach is not currently being used by any payment institutions. The regulations in place for safeguarding these funds are, in broad terms:

(i) effective due diligence on the credit institution where cash is held;
(ii) sufficient records to identify the cash balance per user;
(iii) daily reconciliations; and
(iv) ensuring that the credit institution correctly identifies the account as separate to the payment institution's funds.

Credit Institutions

5.11. The Credit Institutions Supervision Directorate is responsible for supervising credit institutions. Where a credit institution provides investment services, which fall within the scope of MiFID, it must comply with the MiFID requirements. This includes requirements regarding safeguarding any client assets it holds in respect of such activities[23]. Our understanding is that while the detailed provisions of the CAR were not applied, it was considered that general prudential supervision would cover this area. The extent to which this has happened in practice is not clear, particularly given the serious issues in the banking sector. The financial crisis has subjected the credit institutions to intense supervision in respect of their overall business, their overall processes, internal controls and corporate governance.

Insurance Intermediaries

5.12. The receipt of insurance premia by an insurance intermediary is governed by the "Premium Handling" section of the Consumer Protection Code[24]. An insurance intermediary is required to lodge monies received into a separate segregated account which should be designated as the 'Client Premium Account'. The Consumer Protection Code specifies the only debits and credits that can be passed through a client premium account which include items such as money received from a consumer for a policy renewal, proceeds from an insurance undertaking to settle a claim, rebates or commissions and rebates due to the intermediary. The account cannot become overdrawn and where a mixed remittance is received, it must first be paid to the client premium account in total. The intermediary is required to perform monthly reconciliations on the client premium account.

Scope of Firms Covered

5.13. In our report we have focused on investment firms, including FSPs. A specific recommendation in respect of credit institutions is in paragraph 8.51 and credit institutions are not considered further in this report. We regard payment institutions, insurance intermediaries and CISs to be covered by alternative arrangements and are not discussed further in this report.

Proposed Legislative Reforms

5.14. Recent experience suggests that in some respects and at a higher level than the CAR regime itself, current legislation does not provide adequately for all relevant eventualities and needs therefore to be supplemented.

[23] Article 13(7) & 13(8) of MiFID and Articles 16-19 of the Implementing Directive.
[24] Section 3.46 -3.51 of the Consumer Protection Code 2012

5.15. The recommended objectives address the need to mitigate the risk of misuse of client assets whether as a result of maladministration or fraud and to provide for a system which in the event of insolvency will facilitate the speedy return of client assets. The means of achieving these are subject to provisions contained in primary legislation and given the uncertain economic climate in which we live, urgent consideration needs to be given to revising these in the following respects.

Regulatory Intervention in the Management of a Firm

5.16. The lessons being learnt both in Ireland and elsewhere highlight the importance of having the regulatory powers to intervene in the management of a firm at an early stage when suspicions of maladministration or fraud arise. When firms get into difficulties, the risk to client assets increases significantly and regulatory intervention at an early stage would help to protect client assets. The Central Bank can issue directions[25], but this can be unwieldy and is dependent on the existing management for compliance. The Central Bank has no powers currently to intervene more directly in the management of a firm's business short of withdrawing its authorisation[26] and in effect closing it down, or applying to have the firm wound up[27]. Neither of these draconian options may be in the interest of the underlying clients. Other powers are available including the appointment of a Court Inspector[28] or the appointment of an examiner under the Companies Act 1990, but these tend to be more of a reactive than proactive option. We understand that the Central Bank is seeking the inclusion in the forthcoming Central Bank (Supervision and Enforcement) Bill 2011, for the power to apply to the High Court for the appointment of an Administrator to take charge of the affairs of an authorised firm where, subject to certain tests[29]:

(a) there are serious problems of a financial nature; and/or
(b) the interests of investors or clients of the firm are at risk.

5.17. **We recommend however, that the Central Bank be given a power to apply to the court for the appointment of an Administrator or a person with equivalent powers, to take charge of the affairs of an authorised firm on a broader basis, where the Central Bank has reasonable grounds to suspect that:**

(a) there are serious problems of a financial nature ;and/or
(b) the interests of investors or clients of the firms are at risk.

Interface with the Insolvency Regime

5.18. The MiFID Regulations[30] and the IIA[31] both provide that *"No liquidator, receiver, administrator, examiner, official assignee or creditor of an investment business firm shall*

[25] MiFID Regulations 147-148.
[26] MiFID Regulation 21
[27] MiFID Regulation 150
[28] MiFID Regulation 173
[29] These are when one or more of the following applies: The Central Bank has serious concerns relating to the financial stability of the firm concerned; the manner in which the business of the insurer is being or has been conducted has failed to make adequate provision for its debts, including contingent and prospective liabilities; the business has been conducted so as to jeopardise or prejudice the rights and interests of clients and investors; and the firm has become or may become unable to comply with the requirements of the Irish financial services legislation in a material respect.
[30] Regulation 157
[31] Section 52 (7) IIA

have or obtain any recourse or right against client money or client investment instruments or documents of title relating to such investment instruments received, held, controlled or paid on behalf of a client by an investment business firm, until all proper claims of clients or of their heirs, successors or assigns against client money and client investment instruments or documents of title relating to such investment instruments have been satisfied in full."

5.19. Past experience of how this works in practice prompts further consideration as to how the interface between the CAR regime and the insolvency provisions can be improved so that they complement one other more effectively. An administrator or liquidator not only needs to be able to identify assets to individual clients but also to assume control over those assets and be in a position to return them back to those clients as expeditiously as possible.

5.20. In April 2001, W&R Morrogh Stockbrokers ceased trading and lengthy legal proceedings followed. The case highlighted certain important issues in relation to investor compensation arrangements and the management of liquidation/receiverships in the event of the failure of an investment firm. A working group was established to examine the issues arising from the Morrogh's case. The final report of the working group was published in November 2006. The group found that the Administrator[32] appointed by the Central Bank encountered difficulties reimbursing clients of Morrogh and because of the lack of legal certainty he had to seek advice from the High Court on various matters. The working group recommended that legislative changes should be made to ensure that rules were in place to address difficulties which might arise. These are referred to as the "pre-determined distribution rules". A draft for these new rules was commissioned by the ICCL for inclusion in an appropriate Bill. We understand that this is still under review.

5.21. We note in this context that currently the Irish regime appears not to have available to it (at least expressly) the legal and regulatory devices available to the courts and the regulators in the UK with which to manage an insolvency of an investment firm. These are :

(a) the deployment of the concept of a statutory trust as applied to client assets[33]; and

(b) the use of express provisions in the FSA Client Assets Sourcebook (CASS)[34] to provide for handling of client monies on the insolvency of a firm itself ("a primary pooling event") or of a third party at which the firm holds client monies ("a secondary pooling event").

We understand that the pre-determined distribution rules are now contained in a proposed amendment to the Investor Compensation Act 1998 and in effect, provide for the rules applicable to a primary pooling event.

5.22. Notwithstanding these provisions, the experience of the Lehman's insolvency has shown that legal uncertainties remain[35] as to the extent and nature of the entitlement of a client pursuant to the trust and the remedies or powers available to give effect to that entitlement. The sorts of issues which are being addressed are whether the trust attaches to monies which have not yet been segregated whether negligently or innocently; whether it is possible for the trust to exist over a share of the "house" account where monies are mixed with the firm's own funds; concerning the treatment of open positions and whether the firm's

[32] Appointed with the powers outlined in section 33 of Investor Compensation Act, 1998
[33] Section 139 FSMA 2000
[34] CASS 7A.1
[35] These issues will shortly be the subject of a Supreme Court decision in the Lehman's case

liquidator could be required to transfer in to pre-existing segregated client accounts monies representing the value of the positions on the basis of a notional close out at the time of entry into administration; whether clients can participate in the client money pool if they have claims to client money or only if they have contributed to the pool. Consideration is being given to policy options and solutions[36] having regard to those currently provided for in the US[37]. It is highly likely, given the shared common law approach to trusts, that Ireland faces the same legal uncertainties and any new arrangements must necessarily take account of these developments if it is to provide for a system which in the event of a firm's insolvency will enable the expeditious return of client assets to the owner at lowest cost.

5.23. Over and above the legal and regulatory framework which defines the rights of the owner, there have also been developments in the UK to improve the process of insolvency. It is now recognised in Ireland for there to be a need for administration powers with special objectives, such as that to protect the interests of clients with monies or assets entrusted to the firm. This is required due to the particular nature of investment firms and the fact that various types of challenge may arise. The Central Bank and Credit Institutions (Resolution) Act, 2011 (the "2011 Act") provides for something of a "special objectives" administrator regime (referred to as a special manager)[38], but the 2011 Act applies only to authorised credit institutions. The need for this sort of approach has been highlighted by the failure of Lehman Brothers International Europe (LBIE). LBIE was put into the UK's administration process on 15 September 2008. MF Global (UK) was then put into the UK "Special Administration Regime" on 31 October 2011. This regime provides inter alia:

(a) for an administrator to seek to fulfil certain defined Special Administration Objectives, assisted by the power to set bar dates for claims and where there is a shortfall in client assets the power to distribute the remaining assets on a pro rata basis; and
(b) for the FSA to give directions on which of the objectives be given priority.

The experience of this regime has been broadly positive; particularly the provisions maintaining the supply of critical services and the operation of the bar dates for claims. Some tension exists in managing the objective of ensuring the speedy return of client assets with that of the administrator to engage with the market infrastructure bodies. The operation of a new non-statutory protocol with market infrastructure bodies however has been very helpful and contrasts very favourably with what happened in LBIE's insolvency.

5.24. **The economic climate remains hostile and unpredictable. Insolvencies or the impact thereof can occur with little or no notice. In the interest of ensuring that the insolvency regime is best equipped to resolve client assets in these situations, we recommend that urgent consideration now be given to a revision of the existing insolvency provisions in line with the pre-determined distribution rules proposed by the ICCL but taking account of relevant developments elsewhere in particular the UK's Special Administration Regime for investment firms.**

Forthcoming EU Developments

[36] See the Financial Law Committee paper on Client Money Rules. Issue 147 dated October 2011
[37] Section 78fff-2of the US Securities Investor Protection Act 1970 ("SIPA")
[38] See, for example, sections 62(5) and 67(1) of the legislation.

5.25. There are also a number of new proposed and revised EU regulations which are currently subject to consultation. It is not possible now to assess their final form and this may have implications for our recommendations and the CAR when they are finalised.

5.26. However, there are currently published proposals for consultation issued by the EU Commission in respect of MiFID II and the introduction of AIFMD. The introduction of UCITS IV from 1 July 2011 did not have any impact on client asset rules in respect of the existing responsibilities that already applied.

5.27. Finally one other regulation that indirectly impacts client assets is the proposed ICD. For compensation purposes, the proposed directive notes that even where MiFID firms may not be specifically authorised to hold client assets as part of their overall authorisation, it has decided to clarify that all investment services and activities under MiFID should be covered and if the firm de facto holds client assets (even if this contravened its authorisation), an investor is still entitled to compensation. The minimum level of investor compensation in the current ICD is €20,000. An increase in the limit to €50,000 is included in the current proposals. There is still significant debate and discussion on an appropriate compensation limit and no decisions have yet been made on this.

MiFID

5.28. In addition to important, high level requirements of MiFID in respect of client assets, the Central Bank introduced a number of additional safeguards in the CAR using the provisions contained within Article 4 of the detailed provisions (knows as Level 2 measures) of MiFID. Member States were allowed to use discretions where justified under Article 4. Unless this provision changes, we do not believe MiFID II will have a significant impact on client assets. Other features of MiFID, while not impacting on the safeguarding of client assets but which may be relevant in future, are included in Appendix V.

AIFMD

5.29. The introduction of AIFMD by the EU may impact on CIS and other alternative funds including the FSPs, depending on the final definitions particularly where FSPs perform a depositary role under AIFMD[39]. The impact of these proposals for FSPs are also included in Appendix V.

Conclusion

5.30. Proposed and revised EU Directives are not in final form. However, information to date suggests that safeguards we are recommending to improve effectiveness of the regime are unlikely to be adversely impacted by forthcoming changes.

[39] The term custodian or trustee is often used in Ireland to describe the entity known in AIFMD as the depositary

THE CLIENT ASSET REQUIREMENTS (CAR)

Introduction

6.1. The main body of supervisory requirements that regulate the holding of client assets are the CAR. They are imposed under two pieces of legislation; on all investment firms that hold client assets under Regulation 79 of MiFID; and on all investment business firms that hold client assets under Section 52 of the IIA. The CAR details the regulations in respect of the safeguards in place for the client assets, i.e. once the client has proceeded with investing monies and/or financial instruments and has transferred these assets to the firm. The CAR also contains various rules bearing upon the firms' duties towards the client whether concerning the provision of information or requirements for specific client consent[40].

6.2. In assessing the relevance and adequacy of the existing CAR regime, it is important to have regard to provisions of the implementing directive of MiFID[41]. The recitals to this directive acknowledge that:

> *"Investment firms vary widely in their size, their structure and the nature of their business and a regulatory regime should be adapted to that diversity while imposing certain fundamental regulatory requirements which are appropriate to all firms"*[42]*;* and "*A regulatory regime which entails too much uncertainty for investment firms may reduce efficiency. Competent Authorities are expected to issue interpretive guidance on provisions in the Directive with a view to clarifying the practical applications of the requirements to particular kinds of firms and circumstances"*[43].

Article 16 of the Directive which deals with the safeguarding of client assets also permits Member States to prescribe measures that investment firms must take in order to comply with the obligations set out in the Article where for reasons of applicable law, investment firms would not otherwise be able to comply.

6.3. The CAR also derive their authority from section 52 of IIA. This section permits the exercise of a considerable degree of discretion by the supervising authority in the scoping and definition of the client money requirements.

6.4. We conclude from this that, while any regime as defined needs to be faithful to the aims of the Directive and the IIA, each permit some appropriate degree of flexibility to cater for diversity of business types and structure and encourages the use of guidance to clarify practical application of the rules.

6.5. In May 2011, prior to the commission of this task force, a review was conducted of 65 firms[44] to determine if the current requirements remained appropriate ('the original review'). They were invited to comment specifically on:

- aspects of the requirements which cause difficulties in terms of compliance;
- requirements which required clarification; and

[40] CAR 3.1.5, 4.2.7,4.3.8,4.3.10,4.8,4.10.3,4.11,4.12,5.5.1,6.3 and 7.1.1
[41] MiFID 2006/73/EC
[42] Recital (11) MiFID 2006/73/EC
[43] Recital (12) MiFID 2006/73/EC
[44] 35 firms responded, some of whom had no specific comments to make

- those which no longer represent best practice citing, where appropriate, international comparators.

In assessing the effectiveness of these requirements both in terms of scope and sufficiency, we have taken account of the responses to this review as well the views of the supervisory teams who work with them and subsequent discussion with stakeholders.

6.6. The clear consensus is that the CAR merits revision. Having been written on a "one size fits all" basis (apparently with stock-broking firms in mind), they lack flexibility and relevance, leaving insufficient scope for a firm to apply judgement and encouraging a tick box approach to compliance rather than one based on managing the real risks. There are issues as to the form, scope and substance of the requirements, which give rise to inconsistencies in interpretation and application.

The Form of the CAR

6.7. As to the form of CAR we have learnt in our discussions with external organisations that senior management and others who are not working with the requirements on a routine basis have had difficulties understanding the rationale of certain provisions. This is in part because of the awkward and cumbersome way in which they are presented. This we regard as significant as the Central Bank relies heavily for effective regulation on senior management having a clear understanding of the objectives and rationale for the rules.

6.8. The CAR is set out in seven chapters. The introduction, which cites the legislative context and outlines the scope of the requirements, descends into some detail by offering examples of when a firm is holding, or ceases to hold, client assets despite the fact that there follows in a later chapter a specific section on the topic[45]. There are separate chapters setting out General Principles and General Requirements applicable to both financial instruments and client funds (monies) and in many respects the latter is just a more detailed elaboration of the former. There then follow two further chapters dealing separately with more specific requirements applicable to financial instruments and funds respectively, and a final chapter dealing with securities financing.

6.9. The outcome is a rule book which is repetitive in its statement of the requirements, contradictory in certain respects and thereby capable of giving rise to confusion and potential inconsistencies in their interpretation. We give an example of one in relation to the definition of client assets in paragraph 6.12. Another instance is that the General Principles chapter purports in its sub title to relate to financial instruments only:- "*Safeguarding Clients' Rights Relative to Financial Instruments"*, but in fact applies to both funds and financial instruments.

6.10. **We recommend that the presentation of the CAR be revised:**

(a) making greater use of higher level principles reinforced with the appropriate guidance so as to introduce greater flexibility into the regime and a more accessible explanation of the rationale for the underlying rules; and

(b) setting out the rules in a way which avoids unnecessary and potentially contradictory statements and lends itself to more effective compliance.

[45] Contrast CAR 2.1.6 with CAR 4.7

The Scope of the CAR

6.11. The CAR applies only to those firms which fall within the definition of an investment firm as defined by the MiFID Regulations and the slightly broader population of investment business firms as defined by the IIA which notably includes the fund administrators and non-credit institution trustees. The scope of the CAR's application to these firms is determined not only by the services which they provide but also by the financial instruments, as listed in MiFID[46] and IIA[47] which they handle as part of that service. This means that, although some firms will be authorised and regulated in respect of some of the financial instruments they handle, the protective shield of the CAR regime will not extend to all products. Furthermore we understand that in the recent past there have been a number of firms authorised to do investment business where the greater preponderance of business they do does not fall to regulation; this has been particularly prevalent in relation to property investment ventures. The concern is that because a firm is authorised to do investment business, investors will assume that their assets are subject to the CAR when in fact they are not. We believe however that the solution to this concern lies not within the defined scope of the CAR but rather within the authorisation process about which we make recommendations in Section 7.

6.12. With the CAR we have also identified a lack of clarity as to what precisely they apply, i.e. what the term 'client asset' means. The term "client asset" is differently defined in sections 2 and 4 of the CAR. In the former it is confined to monies or instruments which a firm holds 'in the course of carrying on an investment business service'; in the latter it is monies or instruments held in the course of carrying on its activities (undefined) for or on account of that client.

6.13. This has given rise to inconsistencies in interpretation of what constitutes client assets particularly with regard to client monies where there is a mix of regulated and unregulated business within one firm, specifically whether the requirements apply to funds/monies lodged with firms only for the purposes of investment in regulated products or more broadly for the purposes of investment in any product whether regulated or unregulated until such time as they are converted. Most firms we spoke to tend to take the more cautious approach and treat all monies received or held for clients as subject to the CAR wherever they may be destined.

6.14. **We recommend that the CAR be amended to provide a clear and consistent definition of client assets. The wider definition of client assets should be adopted so that the presumption in the requirements be that all client funds received or held by an authorised entity be subject to the CAR regardless of the intended investment.**

6.15. Investments within CIS are subject to UCITS[48] and Non-UCITS[49] Regulations which stipulate that client assets held in a CIS be entrusted to a trustee for safekeeping. The assets in a CIS belong to the fund itself and not to underlying clients. They merely own a unit or

[46] MiFID 2004/39/EC Annex 1 Section C

[47] Part I Section 2 of IIA

[48] Undertaking in Collective Investment for Transferable Securities ("UCITS") subject to the UCITS Directive (2009/65/EC) originally introduced in 1985 and implemented into Irish Law by UCITS Regulations

[49] Non UCITS a category of Irish CIS introduced under the Unit Trust Act 1990 and Part XII of the Companies Act 1990.

share in the fund. The CAR does not therefore apply to the assets in a CIS. These are protected by regulations to which FSPs are subject and are contained in a series of Notices which are updated on a regular basis.

6.16. However FSPs do receive, hold and pay out un-invested cash in DDA accounts. Monies held in these accounts are normally held for less than a day but can be there for up to five days and longer in exceptional cases. These monies are client assets within the meaning of the CAR. The CAR apply to the operation of these accounts but for various reasons, principally the impracticability of their application, they are not in fact applied by any of the FSPs who operate these accounts. We regard this lacuna as unsatisfactory.

6.17. It is undesirable that no appropriate requirements to safeguard client assets are imposed at this stage of the process. This should be resolved.

6.18. **We therefore recommend that a practicable and relevant regime, which draws on best practice, should be developed specific to the operation of DDA accounts. This should be progressed in consultation with the FSPs.**

The Substance of the CAR

6.19. Feedback from the original review and subsequent engagement with stakeholders highlighted areas where it was felt that the CAR are too inflexible; where the rules add nothing to the overall objectives but nonetheless are required to be enforced; and that they tend to focus resources in areas where they are not essential and which could be better deployed elsewhere. Supervisors and inspection teams find that time is spent on enforcing or discussing rules where breaches are not particularly relevant to that firm rather than focusing on the appropriate procedures that should be in place.

6.20. Issues of substance are:

Daily calculations:

- The formula as expressed in the CAR[50] pursuant to which the required amount of a firm's client money resources is calculated on a daily basis, is confusing and the rationale for the buffer of 8% is not evident and it appears arbitrary as it takes no account of the nature of the business being transacted. Many firms therefore query the rationale for the requirement for a buffer calculated by reference to such a precisely defined formula, which fails to make any allowances for the different business models to which it is applied. The introduction of this requirement followed the fallout from the insolvency of the stockbrokers W&R Morrogh where it was found at that time that stockbrokers generally were using one client's money to settle another client's trades where clients had not funded their trades on time. The figure of 8% of settled debtors was chosen. But this approach is not relevant to many of the firms' business models and seen as inappropriate for firms as they simply do not operate in this type of business.
- Although not a matter for CAR itself, the accounting treatment of the buffer is also potentially problematic as the buffer is included in a firm's balance sheet in accordance with accounting rules. Firms are also reporting that cash held for the buffer as capital for regulatory purposes. Accounting for the buffer in this way, namely as the firm's money, might thereby prejudice any claim clients may have to

[50] CAR 5.3

these funds in the event of a shortfall, undermining the original purpose of the buffer.

6.21. **Reconciliations:**

a) **Frequency of reconciliations:** Firms are required to perform daily reconciliations for client monies (within one business day) and monthly reconciliations for client financial instruments (within ten business days). Daily reconciliations are being performed where there is no significant risk or even no new information and it uses resources that could be deployed elsewhere. For example, a monthly fixed term deposit requires a daily reconciliation, even though there are no transactions until the deposit matures and no new statement until the deposit matures. MiFID [51]merely requires reconciliations to be conducted 'on a regular basis' while ensuring that the firm's records can show at any time and without delay, each client's assets individually and in total and clearly distinguishes this from its own money. The FSA gives further guidance on the frequency of reconciliations being 'as regular as is necessary and as soon as reasonably practicable after the date to which the reconciliation relates'[52]. For example, if a firm is performing daily transactions, a daily reconciliation is typically the most appropriate basis.

b) **Breaches and reconciling items:** For some industry respondents there is some confusion over reconciliation items and breaches. Guidance has also been sought on what amounts to a "material" or "recurrent" difference, which are required to be reported within one business day as the CAR does not define either term.

c) The requirement for the **retention of hard copies of reconciliation:**[53] This appears excessive given the ability of firms to retain these electronically. It also reinforces the 'tick-box' approach with firms printing these on a daily basis across many accounts, with the risk that more attention is focused on ensuring the safe retention of these, rather than the conduct of the reconciliation itself.

6.22. **Segregation of client assets:**

A critical feature of the CAR regime's ability to fulfil one of the recommended objectives, namely the provision of a system which in the event of an insolvency will enable speedy return of client assets, is the requirement that client assets be segregated effectively from the firm's assets.[54] This is particularly apposite when the firm places those assets into the hands of a third party, who, it is important, acknowledges for these purposes that the assets belong to the client and not the firm. The CAR requires that the firm procures that such accounts with third parties be designated in prescribed terms.[55] Difficulties have arisen specifically with receiving confirmations from third parties concerning the designation of client accounts in the prescribed terms principally arising from the use of terminology which may be unfamiliar in another jurisdiction. While recognising the importance of achieving mutual clarity and certainty as to the designation of the account as a client account, the use of more commonly accepted terminology to achieve the objective should be considered. The MiFID requirement is only that client funds and financial instruments deposited with a third party must be identified separately from funds and financial instruments held by the firms.

[51] MiFID Article 16
[52] CASS 7.6.10
[53] CAR 4.5.1
[54] CAR 3.1 and 4.2
[55] CAR 5.2

6.23. **Omnibus accounts and general liens on custody arrangements:**
This is a smaller technical point but at least one firm has raised this. The issue relates to whether the CAR recognises the legitimate use of omnibus accounts and general liens, given there is a lack of detail in the regulations. CAR 6.5 addresses Custodian Agreements and at (e) permits a lien or security interest over an individual client's financial instrument in two defined situations but it does not deal with these issues in relation to general liens and omnibus accounts. The FSA has recently been responding [56] to issues which firms in the UK have had with general liens being granted by firms to custodians and sub-custodians over their clients' assets, and client money derived from those assets, held in omnibus accounts. The issues concern:

(a) the difficulty (and costs to the clients which would be incurred) where these assets are held in an omnibus account in the name of a firm in segregating for these purposes individual client assets; and
(b) defining the terms on which liens are permitted to accommodate the jurisdictional issues which arise when client assets are held in other jurisdictions.

6.24. **Insurance**
As a general point, we recognise where there may be practical difficulties applying the CAR, the use of insurance may be considered, subject to Central Bank approval.

6.25. **We recommend that:**

(a) the daily calculation remain a daily requirement;
(b) the purpose of the provision is made clear, i.e. to create a buffer to cover any deficiencies on the account which may arise as an inevitable consequence of the way in which the account is operated; and
(c) the formula used to calculate the size of the buffer is revised so as to deliver a safeguard appropriate to the business model of the firm.

6.26. **We further recommend that the CAR is revised taking account of the points raised from 6.21 to 6.24 and also having regard to the presentation of the client facing obligations on firms. This is not an exhaustive list.**

6.27. **To facilitate the development of a revised and improved CAR we recommend that a joint working group of the Central Bank and Industry be established to develop detailed proposals.**

[56] FSA CP11/15 dated July 2011

THE REGULATORY STRUCTURE

7.1. In this section we address the features of the regulatory structure in addition to the CAR, against which the applicant and authorised firms are assessed and supervised. We consider authorisation; the application of the newly introduced 'Fit and Proper' regime for PCF; a proposed requirement for firms to produce a client asset management plan; and finally matters relating to consumer awareness.

Authorisation

Current Position

7.2. Authorisation represents an important opportunity, through its gatekeeper role, of maintaining and improving the overall standards which the industry applies to the holding of client assets.

7.3. There is an authorisations unit for MiFID firms.

7.4. The authorisation process is primarily desk based as applicants are not typically trading and there is nothing to inspect. The authorisation unit holds a preliminary meeting, usually of about one and a half hours duration, with all potential applicants. This meeting follows a standard agenda, covering issues such as:

- Group structure/shareholders/directors;
- Proposed activities/customer base;
- Governance & internal controls; and
- Policy & procedures on issues such as Minimum Competency Requirements and the Consumer Protection Code.

7.5. Corporate governance and internal controls requirements are imposed on a proportionate basis, determined by size. These requirements are imposed under MiFID, having due regard for the nature, scale and complexity of the business as set out in MiFID. For example, firms subject to CRD require at least one independent non-executive director. Firms with a strong retail base require two independent non-executive directors, an internal audit function, and segregated compliance and risk functions. Segregation of front and back office is also required.

7.6. Where an applicant forms part of a group, the authorisation units considers where the firm sits in the group structure, whether consolidated supervision should be applied and if so, by whom. It also considers whether the group forms a financial conglomerate. It looks at interactions within the group, with particular focus on outsourcing arrangements and where control is exercised. In addition, the group structure is analysed to identify close links and also to consider access to funding.

7.7. For firms proposing to hold client assets, the focus is on reviewing the transaction flows to form a view as to whether or not client assets will be held. The authorisations unit considers

where the firm is depositing the assets in the first instance, to ensure appropriate segregation, and also considers the controls and procedures which will operate over client assets. Firms proposing to hold client assets must provide details of who will be doing the reconciliations and who will do the independent checks (the independent checker cannot be involved in trading). However, there is no consideration as to whether it is appropriate, from an overall risk perspective, to allow the applicant to hold client assets.

7.8. The turn-around time for authorisation tends to be 4-6 months. However, this can be substantially delayed, if there is a prolonged period of time between the preliminary meeting and the Central Bank receipt of the application.

7.9. Where a firm is authorised, which will be holding client assets, a specific condition is put on the authorisation, requiring it to comply with the CAR.

7.10. Where authorisation is granted to a firm, which will not be holding client assets, a specific condition is put on the authorisation, stating that the firm may not hold client assets.

7.11. The current register of authorised firms does not disclose whether a firm is authorised to hold client assets.

7.12. The table below details the number of authorisations granted in the last five years.

Year	Firms authorised (total)	MiFID	IIA	Firms Holding Client Assets
2007	15	11*	4	2
2008	11	10	1	5
2009	12	12	0	4
2010	4	4	0	0
2011	2	2	0	1

* includes IIA firms authorised under Section 10 of the IIA during the year and deemed authorised as MiFID entities on 1 November 2007 (in accordance with the legislation)

Observations

7.13. Holding client assets does not automatically trigger consideration of more onerous regulatory requirements, other than the requirement to comply with the CAR. There is no evident consideration of the desirability of applicants holding client assets, based on an assessment of risk.

7.14. At authorisation stage, where a firm proposes to undertake unregulated business as well as regulated business, no consideration is given to the preponderance of unregulated business. Firms are however required to disclose clearly to clients where business is unregulated. Carrying out unregulated business in tandem with regulated business at a minimum increases operational risk and is also likely to create uncertainty in the minds of clients.

7.15. The information flow between the authorisation unit and the supervisors is focused on the hand-over of newly authorised firms. Information flows to the authorisation unit about practical issues arising from supervision are ad hoc.

7.16. CPC's involvement in the handover process is limited.

Recommendations

7.17. **An application by a firm to hold client assets should be considered more holistically, using risk-based techniques so that the range of the firm's activities, its governance and processes can be fully assessed.**

7.18. **All authorisations to hold client assets should require sign-off from Central Bank specialists, which would include a review of the applicant's own arrangements for safeguarding of client assets.**

7.19. **Authorisation to hold client assets should trigger consideration of additional corporate governance and internal controls requirements, such as a requirement to have an internal audit function, a requirement to have segregated compliance and risk functions and a requirement for two independent non-executive directors.**

7.20. **Where authorisation to hold client assets is granted, unregulated business should not exceed 10% of turnover.**

7.21. **The registers of firms should disclose which firms have authorisations to hold client assets.**

7.22. **For newly authorised firms, authorisation information, including a copy of the memorandum of recommendation and the letter of authorisation, should be copied to CPC. In addition representatives from CPC should attend handover meetings for newly authorised firms.**

Pre-approved controlled function

Current Position

7.23. Rigorous senior management oversight of the controls and processes in place to safeguard client assets is critical. Different business models will have different levels of risk to manage in terms of the nature of client assets they hold, the control systems in place and their overall oversight environment.

7.24. The components of senior management oversight can and do vary according to the size of the firm, the nature of the assets held and the different jurisdictions in which it may operate. The process of monitoring the safeguards in place for client assets from the moment of agreeing the investment mandate and receipt of the initial asset to the final return of assets can be complex and in the majority of cases, will involve different people (appropriately given the importance of segregation of duties) and different departments. Firms may operate many of the processes in distinct silos from an operational prospective.

Observations

7.25. It is evident from the Central Bank's experience in the event that client assets issues arise, there can be difficulty in establishing who has overall responsibility for compliance with the CAR as a whole. Matters may fall between different departments resulting in a lack of oversight and increasing potential risks to client assets. Furthermore, it appears that

responsibilities can often default to the compliance department who may not have the necessary skills in understanding a firm's operational systems and finance controls to effectively perform this type of role.

7.26. The Central Bank's experience is consistent with the FSA and, in response, the FSA have recently introduced a new CASS operational oversight function, referred to as 'CF10a'. This role is to ensure that there is one person with ultimate oversight responsibilities for client assets even if the firm structures its business so that several people across different departments have relevant roles. The role includes general oversight of the firm's compliance with CASS, reporting to the firm's governing body in respect of the oversight and completing and submitting the client assets return.

7.27. In the next section we recommend the introduction of a requirement for a CAMP which would bring together a firm's overall approach to risks associated with safeguarding client assets across the entire firm, detailing not only the controls and operational process but how a firm would return assets to a client in an expeditious manner in the event of insolvency. An individual responsible for the overall oversight of client assets would naturally fit with the production of CAMP and would assist the firm not only in identifying all risks and mitigants but also in identifying where potential gaps, or indeed overlaps may exist.

7.28. It is important to note that the appointment of a PCF to this area is not a substitute for overall board responsibility for safeguarding client assets. However, the role of the PCF does mean that additional focus is applied to client assets within the firm by virtue of appointing a senior management individual to the role. This can give the PCF appropriate leverage if required to ensure that the resources needed for compliance with the CAR are in place and for highlighting issues on a timely basis. In the experience to date of the FSA, the PCF has been a really useful resource for industry messages, gathering information such as short notice surveys and providing invaluable assistance during inspections.

7.29. For most firms, we expect that the PCF will be a director. For the largest and most complex firms, it may not be practical for the PCF to be a director and a member of the senior management team may perform this role. The Central Bank is unlikely to define prescriptive rules as to the qualifications required but it is expected that the firm would be able to explain clearly the basis of nomination of the PCF including qualifications, experience and the demonstration that the PCF is independent from conflicts of interests in this area. It is anticipated that the approval process for the person nominated for the Client Assets PCF would follow the guidance issued by the Central Bank on 23 November 2011.[57]

[57] See Final Guidance on Fitness and Probity Standards, November 2011. http://www.centralbank.ie/press-area/press-releases/Pages/FitnessandProbityIndustryUpdate.aspx

Recommendation

7.30. **It is recommended that a Client Assets PCF is introduced for all firms which hold or intend to hold client assets. The PCF would have overall responsibility to the firm's governing body and the Central Bank for oversight of client assets within the firm. The PCF and the board as a whole would also be responsible for sign-off on the firm's CAMP. The guidance issued by the Central Bank regarding the approval for PCFs should be followed. A risk-based approach should be adopted in deciding whether these PCFs would be called for interview by the Central Bank.**

Client Asset Management Plan

Current Position

7.31. As discussed in Section 6, the current CAR rulebook is inflexible as to its form. It does not reflect the variety of potential business models of firms that hold client assets and the practical application of appropriate controls in place to safeguard client assets. We also have in mind the objectives of the CAR as set out in Section 3, which includes provision of a system to enable the expeditious return of client assets in the event of a firm's insolvency.

Observations

7.32. A firm's business model and arrangements for the safeguarding of client assets are rarely set out in one document. Without such a plan, senior management may not have a full understanding of the arrangements, requirements, risks and mitigants in their firm. Supervisory and external reviews may be impeded as would the work of an insolvency practitioner in the event of a liquidation.

7.33. There is often no formal description of the firm's business model, the key risks to client assets, a summary of the firm's approach to managing these risks including information used to monitor compliance and finally of how the board demonstrates its oversight over client assets.

7.34. Supervisors are not always fully aware or kept up to date with the business model of a firm, including for example, relevant matters such as types of products, including a specification of the level of unregulated business, mandate types, number of clients (and type) or how management monitor business performance (essentially management information) and risks. There is typically no complete map of a business model which would assist in showing the cash flows from end to end as applied to the firm.

7.35. Examples of detailed information not readily available are:

- Key judgments applied by management (such as, materiality both quantitative and qualitative, use and amount of buffer, selection of counterparties, decisions to sell new products, approval processes and link to client asset risks);
- System and operational issues: details of counterparties, systems for preparing reconciliations, frequency of reconciliations, location of all written confirmation letters, information on key reports generated and how generated, how to access the systems and check who has had access to them, information on access rights including journal posting process and approvals and how to run reports if needed for

an insolvency practitioner (eg cash lists by client, stock by client and stock type, date of receipt of cash by client.) In the event there are unregulated products, how the system manages these and separately identifies them; and

- Complaints and breaches; how defined and dealt with including overall monitoring by management of complaints and breaches.

7.36. Much of this information should already be documented, albeit possibly in various different places. However, even where aspects are documented, there can be lack of clarity as to whether it is current and up to date, as events dictate.

7.37. It is difficult for the Central Bank without the information as noted above to 'risk rate' firms holding client assets. A graded supervisory approach deploying resources is not facilitated and may not be sufficiently focused on mitigating individual firm and sector risk.

Recommendation

7.38. **We recommend that all firms holding client monies and client financial instruments (together 'client assets') should prepare a CAMP. This would assist the Client Assets PCF in their role. It should also assist the work of Central Bank specialists not only in enabling appropriate risk-based monitoring of individual firms, but to assist in peer review and sectoral risk identification when used in conjunction with the other information available to the Central Bank.**

7.39. CAMP would also assist examinations by external auditors and third parties and in the event of an insolvency, an insolvency practitioner.

7.40. It should be kept current and reviewed at least annually by the firm and its board. Changes should be documented with a key changes document submitted to the Central Bank or confirmation that there has been no change. Updates should be documented on PRISM or wherever static data is recorded which will then determine if a trigger event is identified.

7.41. An updated CAMP would also be required in the event of significant changes for example, change in structure (both ownership and governance), new systems and controls resulting from that, change in business model (new business product or segment material to the firm).

Consumer Awareness

Current Position

7.42. The register lists authorised investment firms but the condition of authorisation permitting the firm to hold client assets is not publicly available. This is addressed in the recommendation noted in paragraph 7.21

7.43. The position is further complicated where a regulated firm deals in a mix of regulated and unregulated products which may not be apparent to the consumer.

7.44. There is limited information available to consumers with respect to what the firms' obligations to them should be.

Observation

7.45. In our view, the present arrangements do not facilitate adequate awareness by consumers of the risks attaching to the safeguarding of client assets and protections available.

Recommendation

7.46. **We recommend that the Central Bank engage with the National Consumer Agency (NCA)[58] to highlight key factors for consumers to consider in order to understand the risks and make informed decisions.**

[58] The NCA is a statutory body established by the Irish Government in May 2007 to enforce consumer law and to promote consumer rights.

THE SUPERVISORY APPROACH AND USE OF ENFORCEMENT

Introduction

8.1. In this section, we assess the various elements of the supervisory approach including internal organisation, inspections, review meetings and external CAR audit reports. The recommendations in respect of these elements are inter-related and we therefore present them as a comprehensive package from paragraph 8.44 onwards of this section.

8.2. Upon authorisation, responsibility for supervising a firm is handed over to the relevant division for ongoing prudential supervision. For firms which are subject to the CAR, this is either ISPS or Markets and Stockbrokers Supervision Division (MSSD). The divisional structures and processes are considered in more detail below.

8.3. The prudential supervision of firms holding client assets involves four main processes:

a) Receipt and review of periodic financial reports and ad hoc reports from firms;
b) Participation in review meetings;
c) Inspections of firms' compliance with regulatory requirements including the CAR at the firm's offices; and
d) Bi-annual review of firms' compliance with the CAR by the firm's external auditors. The resultant report is submitted to the Central Bank by either the firm or the auditors.

In addition, there are less frequently used processes, such as:

e) Increased capital requirements (capital add-ons);
f) Externally commissioned reviews; and
g) Enforcement action.

8.4. The prudential supervisors may interact with CPC and Enforcement in specific circumstances, but there is not necessarily continuous ongoing engagement. Supervisory work in respect of safeguarding of client assets is carried out in a number of areas and is not brought together. While some of these areas operate quite closely due to organisational structure, others may be more separate and siloed.

Structure

8.5. Two divisions within the Markets Directorate have responsibility for client asset supervision. These are:

a) **ISPS** supervises investment firms[59] (excluding stockbrokers) authorised under the MiFID and investment business firms [60] (excluding FSPs) authorised under the IIA for compliance with the CAR. ISPS is also responsible for supervising payment

[59] 110 at 31 December 2011 (another 19 MiFID firms are supervised by MSSD & one is supervised by Funds Authorisation and Supervision Division (FASD)
[60] 12 at 31 December 2011

institutions'[61] compliance with client asset protection requirements set down in the Payment Services Regulations. Although the payment institutions are not subject to the CAR, they can hold users' funds and are subject to the users' funds requirements.

There are four supervisory teams responsible for investment firms subject to the CAR. There are currently three dedicated inspection units, which carry out inspections of these firms. There are two supervisory teams that supervise payment institutions and bureaux de change. Inspections are carried out by the supervisory team.

b) **MSSD** has one team which supervises stockbrokers[62] authorised under the MiFID for compliance with the CAR. Client money supervision, including inspections (unlike ISPS), forms a core part of the prudential team's responsibilities.

8.6. A third division **FASD** within the Markets Directorate supervises FSPs[63]. The supervision of FSPs is divided between three separate supervision teams. This division does not have supervisory processes specific to compliance with the CAR and therefore comparability with processes adopted by both ISPS and MSSD is of limited value. It is important to note, however, that when inspecting fund administrators, FASD assesses the operational workflow between the subscription/redemption accounts and the funds' accounts, the naming convention on these accounts and the name of the counterparties holding these accounts. It also assesses the adequacy of the reconciliation process and its frequency.

Review meetings & financial returns

8.7. In ISPS, supervisors meet with a firm's senior management at review meetings. These take place at least once every four years. Firms holding client assets are currently considered higher risk, and have more frequent review meetings.

8.8. In ISPS, financial returns are submitted by firms to demonstrate compliance with the requirements of the CRD. Depending on the level of investment activities contained in a firm's authorisation, it must submit certain financial information to the Central Bank, with the frequency of reporting being monthly, quarterly or six-monthly and within 20 business days of the relevant reporting period end. This financial information includes details of client funds held if applicable.

8.9. The approach to supervision of stockbrokers applied by MSSD is very similar to that for firms in ISPS. However on a weekly basis, stockbrokers submit details of the client money that they hold and in addition on a monthly basis they submit details of both client money and client assets. The information sought has its genesis in issues arising from the failure of two stockbrokers in 1999 and 2001.

8.10. The main objective of reviewing the returns is to ensure that a firm is continuing to meet its capital requirements and to assess its liquidity position. The returns do not give any indication as to whether the firm is continuing to comply with CAR – the returns are statistical and contain no attestations as to compliance.

[61] 11 at 31 December 2011
[62] Seven as at 31 December 2011, plus ten other MiFID firms, nine of which are related to stockbroking firms.
[63] 80 at 31 December 2011

8.11. Specific statistical reports are also submitted in relation to client money. Key points in relation to these reports are:

a) Firms submit monthly returns on client assets through the online reporting system; and
b) There is no formal procedure for reviewing these – it is up to the supervisor's discretion and there are disparate views as to the objective of these reviews.

8.12. Currently there is limited capacity to analyse returns. During 2011 the Central Bank executed a project to enable investment firms (including stockbrokers), payment institutions and fund service providers to submit the bulk of their regulatory returns electronically via the Central Bank's Online Reporting System. Returns were transitioned onto the system in three phases during the year, with the final set of returns going live on 31 December 2011. The final phase of the project, due to complete in early March 2012, is focused on internal data presentation and analysis. It will include the development of macro industry analysis and micro firm analysis tools, enabling supervisors to examine firms' key performance and risk indicators against relevant peer groups. It will also include the development of a number of management reports which will highlight outliers and exceptions.

Inspections

8.13. The inspections unit in ISPS was set up in April 2007 and by 31 December 2011 it had carried out 90 inspections, 48 of which involved an inspection of CAR compliance. The inspection unit maintains a log of all MiFID firms supervised within ISPS, which details a history of inspections and reviews. On an annual basis, as part of the planning process, the inspection unit selects firms for inspection. This is focused on the risk profile of the firm and not specifically on client assets. No sectoral analysis is undertaken, with selection driven by other considerations such as supervisory judgement.

8.14. The types of inspections which may involve CAR compliance fall into four categories:

- **General inspection**: This involves examining two or three topics over a four to five day period;
- **Themed Inspection:** This involves selecting five to ten firms for assessment of a single area. In 2009 and 2010, 11 CAR inspections were outsourced to professional service firms;
- **Focused Inspections:** These are one day inspections that focus on a very narrow part of the firm's compliance work. They are done in series of up to ten firms and run over a couple of weeks. While they are not regularly used for CAR inspections, they are used occasionally; and
- **Themed re-visit:** As in early 2011, when a total of ten firms which were previously inspected for the CAR were subject to a re-visit inspection. The purpose of this inspection theme was to assess remedial action taken on findings identified.

8.15. Further key observations on the inspections process are:

- The inspection teams are nearly entirely made up of former members of supervisory teams. There is open communication between inspection and supervisory teams who are located in the same open plan office;

- Whilst supervisory themes are identified as part of the annual inspection planning process, there is no formal analysis of all the supervisory issues that have been identified during the previous year, nor is a sectoral analysis of client asset issues undertaken;
- The inspection process does not involve tracking a particular client's money from receipt through to investment. Rather compliance with specific requirements is checked;
- Inspectors seek a sample of reconciliations and client money calculations in advance. They discuss these with the firm's staff, and match them to underlying documentation. The reconciliations are also checked for appropriate sign-off. Further sampling may take place on-site;
- Inspectors rarely look at client statements and confirmations are not sought from clients;
- Inspectors do not carry out random verification;
- At the close out meeting issues that have arisen on an inspection are communicated to the firm. This normally happens immediately at the end of the inspection and inspectors do not therefore normally discuss these issues with the firm's supervisors in advance of the close out meeting. Any judgement arising from the issues identified would not be disclosed at the close out meeting but would be discussed with the supervisors back at the Central Bank; and
- The inspection report and a draft of the letter are sent by the inspection team to the supervisory team within two weeks of the inspection. The supervisory team issues the post inspection letter to the firm. The timeline for doing so is within one week of receiving the inspection report. There is no formal system to flag overdue post inspection letters.

8.16. The key difference between MSSD and ISPS is that in MSSD the supervisory team, rather than a dedicated unit, carries out inspections. The process itself however is very similar.

Observations

8.17. Client asset supervision is currently undertaken within two separate divisions. As a consequence, although the fundamental principles are the same, there are operational inconsistencies. In addition, we have observed interpretational differences regarding the CAR. This is evident in both off-site and on-site supervision.

8.18. There is currently no consistent, systematic approach to identifying those firms holding client assets which present the greatest risk to the security of those assets. In addition, there is no clear link between client asset returns and a risk-based approach to supervision. The value of the returns in their current format is questionable, and these are not reviewed or used in consistent manner by supervisors.

8.19. There is currently no consistent, systematic trigger-based supervisory approach for firms holding client assets.

8.20. Supervisors and inspectors currently supervising client assets are not dedicated solely to that task. This creates a risk that this area may not be sufficiently prioritised and that broad sectoral and indeed cross-sectoral issues may not be identified. In addition it constrains the development of specialist resources.

8.21. Although there are general governance and oversight structures for supervisory issues, there is currently no forum bringing together the key internal stakeholders, specifically tailored for client asset issues. As client asset issues can require immediate intervention, this gap could lead to undue delay. In addition, there is a risk of inconsistency.

8.22. There is currently no single individual below the level of Director with responsibility for cross-sectoral client asset supervision. While individual divisions have engaged with industry through initiatives such as workshops and *Dear CEO* letters, there is a risk of lack of consistent, high-level engagement with industry and service providers on client asset issues. There is no single area which is responsible for ongoing review of the supervisory practices in place in respect of client assets, to compare to best international practice. Engagement with CPC can be ad hoc, despite the strong link between the conduct of business issues and client assets issues.

PRISM

8.23. We note that the introduction of PRISM, details of which are contained in Appendix VI, will change the general supervisory approach within the Markets Directorate.

8.24. PRISM sets out a minimum level of resources which must be devoted to firms in different impact categories. Supervision of client assets is subsumed into this minimum number and may not be sufficient for the measures we are recommending. However, the functionality available within PRISM, will allow a risk-based approach.

External Audit Reports

Auditor Obligations

8.25. Under the current regime, investment firms and stockbrokers regulated under MiFID and/or section 52 of IIA are subject to an external audit review in respect of client assets.[64] Certain administration firms regulated under Section 52 of IIA although technically subject to CAR have not in practice been subject to any external audit review in this area. Under CAR 4.9 "*the firm is required to ensure that its external auditors:*

(a) Examine the books and records of the firm in relation to client assets;
(b) Review the systems and procedures employed by the firm in relation to the safe-keeping of, and accounting for, client assets; and
(c) Examine compliance by the firm with these Requirements.

on an annual basis, or more frequently as required by the Financial Regulator, and report in a format acceptable to the Financial Regulator stating, whether, in their opinion, these Requirements have been complied with."

8.26. Miscellaneous Technical Statement 47 ('M47') was issued in September 2006 by Chartered Accountants Ireland to provide guidance to auditors of investment firms and stockbrokers on the nature and extent of the work to be undertaken when reporting on compliance with the CAR. M47 originally provided guidance for auditors on compliance with Client Money

[64] The legislative basis for this is under Section 33 of IIA and under section 144 of the MiFID regulations.

Requirements (CMR) which preceded the CAR. M47 was not updated at the time that the CAR was introduced.

8.27. The CAR requires that auditors' reports are submitted annually. However, in 2008, all firms were requested to provide bi-annual reports to the Central Bank given the market turmoil at the time. This requirement still remains in force. The deadline for receipt is within two months of the interim financial period and within three months for the final financial period.

8.28. While an Auditor Protocol has recently been introduced[65], which is applicable only to auditors of firms rated High Impact under PRISM, there are no general requirements on auditors to meet the Central Bank. Obligations on auditors to report to regulators are established through (i) legislation i.e. via Statutes and Statutory Instruments and (ii) Auditing Practices Board (APB)'s requirements i.e. via International Standards on Auditing (ISA) and Practice Notes and Bulletins issued by the Auditing Practices Board.

8.29. Legislation[66] requires the auditor to provide certain other information to the Central Bank as appropriate[67]. Auditors are also required to comply with ISAs. The relevant auditing standard is ISA (UK and Ireland) 250 the "Auditor's Right and Duty to Report to Regulators in the Financial Sector".

8.30. In the UK, in 2011 a new auditors' report and reporting regime was introduced following a review where the FSA felt there were significant shortcomings in the auditors' reports and quality of work which indicated a general weakness with auditors' reports, not just issues localised to a few firms. This has been illustrated also in failings highlighted in the UK with respect to CASS breaches at JP Morgan where the auditors have also been fined for their failure to identify the issue[68].

8.31. Key changes to auditors' reports now adopted for CASS include:

(a) Clarified expectations of the level of assurance required;
(b) Requirement for the auditors to report all CASS rule breaches noted during the period; and
(c) Requirement for firms' governing bodies to review the findings of auditors' client assets reports and provide comments on the breaches identified.

[65] Published by the Central Bank on 6 December 2011 for auditors of regulated financial services firms

[66] The principal act that governs the relationship between the Central Bank and Auditors is the Central Bank Act, 1997 (as amended), specifically Sections 27 (B) – 27 (F) and Sections 27 (B) – 27 (D)

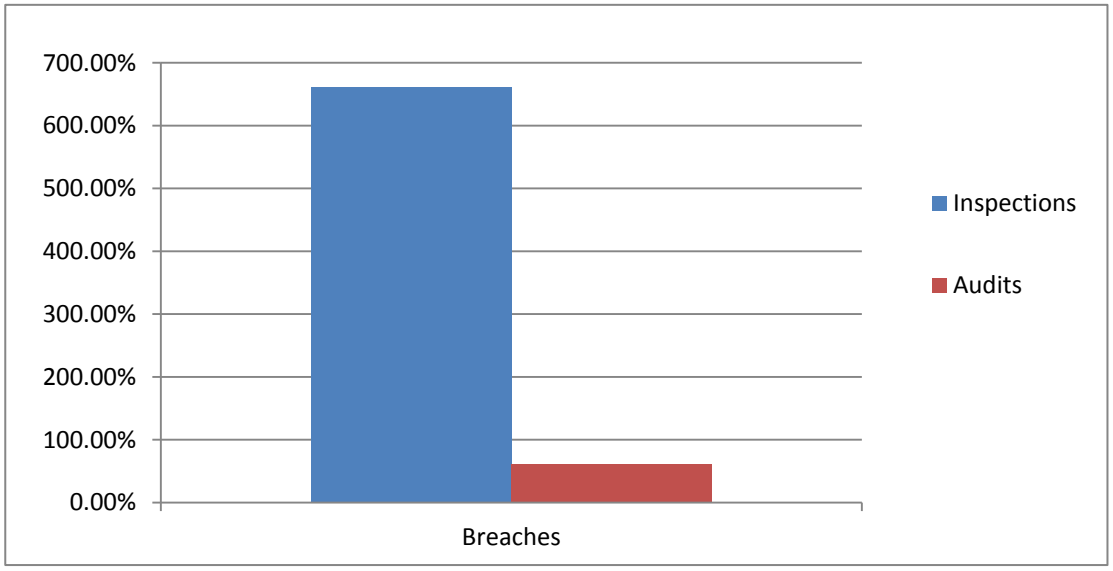
[67] These include (i) An annual confirmation as to whether there are matters to report in addition to and including any reports already submitted under "prescribed enactments" ;
(ii) Copies of any reports provided to the firm or those concerned with its management on matters that have come to the auditor's notice while auditing the financial statements of the firm or carrying out any work for the firm of any kind specified by the Central Bank;
(iii) Copies of any report issued to the Office of the Director of Corporate Enforcement;
(iv) A report on all or any of the following:
  a. The firm's accounting or other records;
  b. The systems (if any) that the firm has in place to ensure that the firm acts prudently in the interests of its members and the interests of those to whom the firm provides financial services;
(v) Any other matter in respect of which the Central Bank requires information about the firm, or the firm's activities, to enable the Central Bank to perform a function imposed on it by or under an Act.

[68] PwC were fined £1.4million by the Accountancy and Actuarial Discipline Board.

CAR Audit Process

8.32. Based on a review of Central Bank inspections since the introduction of the CAR, 284 individual breaches in 43 inspections [69] were identified. Audit reports identified 110 individual breaches in 178 audits.

Expressing breaches as a percentage of inspections and audits:



8.33. Explanations received from auditors fell into a fairly well defined set of categories:

(a) the audit is only based on sample testing;
(b) the issues were not material; or
(c) the auditor did not wish to draw attention to issues of which the Central Bank was already aware.

Observations

8.34. The main advantage of the current CAR audit process is that it gives an independent external review of the firm's compliance with the rules and imposes a discipline on firms as they know that they have to undergo the process. Without this review, there may be more breaches of the CAR. However, the current process adds little real value. The current receipt of bi-annual audit reports does not appear to have enhanced compliance with few matters being reported by audit firms relative to the Central Bank's own findings. The Central Bank needs assurance that firms are complying with the CAR on a continuous basis. Currently CAR audits may provide a level of comfort which is not warranted, particularly with regard to the mitigation of the risk of fraud and maladministration; detection of risk may be hindered by firms having advance notification of the visit, the predictability of the programme and the lack of consistent approach to obtaining external confirmations.

[69] Based on results of inspections up to September 2011

8.35. The nature of audit work in respect of client assets in a specialist area and relevant skills and expertise are required by the audit firms to perform this. There are 23 different audit firms [70] currently performing the work which may mean that there is a lack of experience and appropriate expertise across all audit firms in this specialist area. Of the firms subject to a CAR audit, approximately one-fifth of the firms are audited by an audit firm with only a single CAR audit client. The 'Big Four' audit firms perform just over half of all the CAR audits, with the remaining CAR audits being performed by 19 different firms.

8.36. The current overlap between the CAR audits and the Central Bank's own inspections is not the most efficient use of resources. They should complement rather than replicate each other. Judgement is also applied by both management and the auditors in the context of compliance with the CAR and related materiality issues but there is insufficient visibility to users of the final report as to where key judgements are applied, how this is done and the firm's overall framework of control in respect of client assets.

8.37. There are no channels for communication at present between the Central Bank and the auditors other than the receipt of the standard audit report. Therefore there is no mechanism for discussion to enable a broader understanding of the basis for the report or nuances contained within it.

8.38. The use of the term 'audit' is viewed as misleading and may also result in false assurance to the firms and the Central Bank. This term, to most users relates primarily to the statutory audit of financial statements and the level of assurance received extends to a 'true and fair view' opinion.

8.39. The CAR audit does not report on the amount of client assets at any stage. The work performed by auditors from a CAR compliance perspective is not as clearly defined and potentially measurable as an opinion on financial statements. The degree of assurance that the report provides is not as clearly understood nor as familiar as the audit opinion concept on financial statements. The CAR audit opinion as prescribed by M47 has focused on compliance with the CAR and does not extend to reporting on the systems and procedures employed by the firm in relation to the safekeeping of client assets.

Unregulated Business

Current Position

8.40. The process considered above relates only to the regulated activity of a firm. There are no restrictions on the level of unregulated activity which an authorised firm may undertake.

Observations

8.41. A firm holding client assets in respect of regulated and unregulated activities carries a greater operational risk due to the increased layer of complexity and lacks transparency.

8.42. The current position may create incentives for firms to structure activities so that certain elements fall outside the client asset regime, thus reducing regulatory oversight. Such structures weaken protections available to clients.

[70] Based on figures complied as at 31 October 2011

8.43. The present structure and processes do not allow a co-ordinated approach in this important area.

Recommendations

8.44. In summary our key concerns with the present arrangements are:

- Responsibility for ensuring compliance with the CAR is split over a number of supervisory and inspection teams which does not facilitate a consistent approach;
- There is no consistent systematic trigger-based approach;
- The financial returns do not assist in assessing compliance with the CAR;
- There are no formalised escalation procedures in particular for emergency situations;
- The external CAR audit reports provide a level of comfort which is not warranted; and
- There is no single point of focus for engagement.

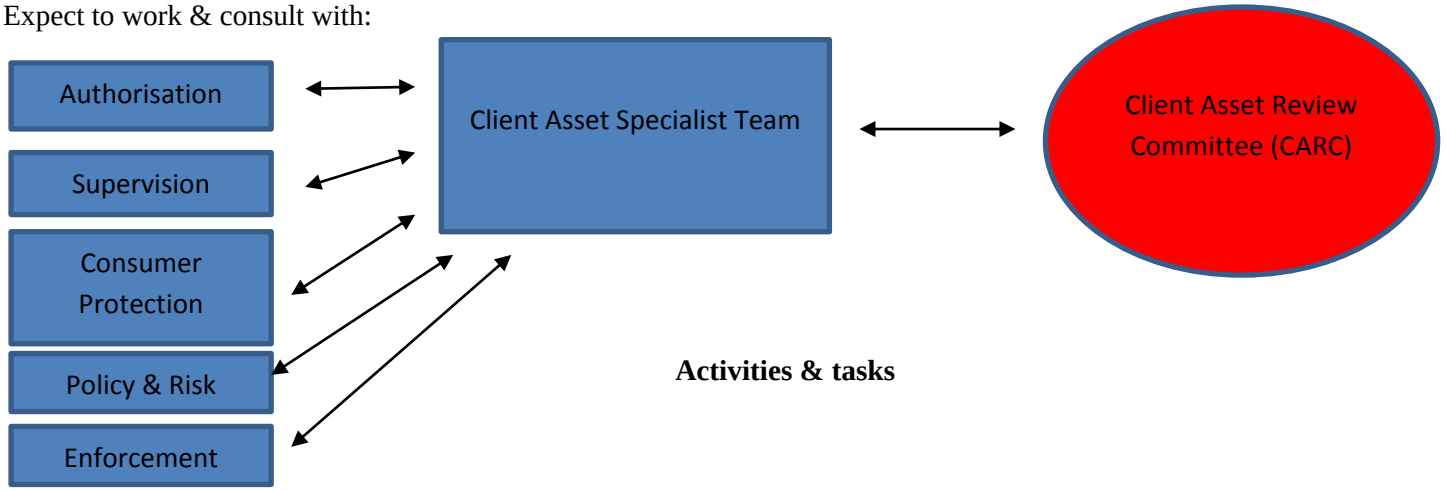
8.45. In developing our recommendations, we have had regard to both structures and processes. Our recommendations regarding structure are that a dedicated unit be set up and that a new decision-making committee be established. From a process perspective, we have looked at the application of a risk-based approach and, outside of "business as usual" issues, trigger-based interventions. We have also recommendations regarding external audit reports and the use of skilled persons. The diagram in Appendix IX shows how all these pieces of the recommended supervisory approach fit together.

Client Asset Specialist Team (CAST)

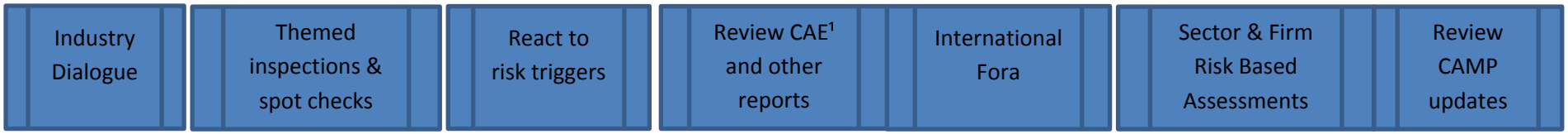
8.46. **As illustrated on the next page, CAST with cross-sectoral ownership for client asset risk should be established. CAST should liaise closely with primary supervisors and should report directly to the Markets Director.**

CAST

Expect to work & consult with:



Activities & tasks



[1] Client Assets Examination report prepared by auditor

8.47. The level of resourcing of CAST should be determined based on the tasks and responsibilities which it is to discharge. Based on the population of MiFID and IIA firms, we anticipate a team of seven, plus a manager. CAST should be a multidisciplinary team, and the background of its members should reflect this. CAST should be headed up by a senior manager, at Head of Division level. CAST should undertake a number of tasks, including:

- review of CAMP (detailed in sections 7.31 to 7.41);
- client asset inspections;
- verification spot checks of client assets;
- production of management information regarding client assets, including firm risk maps and sectoral risk maps;
- sign-off on whether applicants should be allowed to hold client assets;
- industry dialogue, including speeches and other public engagements, on client asset issues;
- keeping informed about international developments and best practice, and where relevant, updating the supervisory approach to incorporate these developments; and
- sign-off on any derogations from the CAR.

8.48. In carrying out its review of CAMP, CAST should be mindful of the possibility of requiring a firm to hold additional capital. All MiFID firms are subject to the CRD which sets out the minimum capital requirements which firms are required to meet for credit, market and operational risk. The Central Bank may impose a specific own funds requirement in excess of the minimum requirement ("capital add-on") set out in the Directive[71], to capture risks within the firm, including risks pertaining to the firm's governance arrangements, risk processes and internal control mechanisms[72].

8.49. This is particularly relevant in the following scenarios:

(a) Where firms are already authorised to hold client assets but do not meet the requirements set out for applicants that wish to hold client assets, the imposition of a capital add-on, reflective of the heightened inherent risk, should be considered to cover the time period during which the firm makes arrangements to be compliant; and

(b) For authorised firms holding client assets, where a firm's unregulated activities exceed 10% of turnover, consideration should be given to reflecting the increased operational risk by the way of an appropriate capital add-on.

8.50. It is intended that the specialist skills of CAST will complement the primary role of the supervisory team and it is imperative that both work closely together. For example, any proposed capital add-on should be agreed with the primary supervisors at a forum such as a risk governance panel.[73] Appendix VII provides additional information as to the

[71] Article 136 of 2006/48/EC
[72] Article 22 of 2006/48/EC
[73] A risk governance panel is a forum whereby the specific risks of a firm are considered in-depth by a cross-organisational panel, and appropriate risk mitigants are agreed. The frequency of panel meetings is prescribed under PRISM.

envisaged functions, team structure, the required experience and the interactions with other specialist areas.

8.51. As part of the implementation consideration should be given to a further two areas:

(a) CAST's role in relation to credit institutions' compliance with MiFID client asset requirements; and

(b) the supervision which should apply to control of client assets.

Risk-based Approach

8.52. **Although CAST resourcing will be additional to the minimum resourcing mandated by the PRISM framework, effective use of this additional resource requires a risk-based approach, which dovetails with the opportunities presented by PRISM. This approach should allow additional differentiation of risk between firms holding client assets, above and beyond the risk differentiation within PRISM.**

8.53. Two different levels of engagement by CAST are recommended in respect of client assets; routine or enhanced. Tasks associated with the engagement levels are to be undertaken by CAST. Enhanced engagement should be reserved for those firms which are perceived to carry the greatest relative risk in respect of client assets. Risk in respect of client assets should be measured by reference to prescribed risk indicators. Client asset returns should be amended to incorporate information in respect of these prescribed risk indicators, once these have been finalised. Both the risk-scoring and the required engagement of this approach should be captured within PRISM. Appendix VIII provides additional information on this proposed approach.

Trigger-based Interventions

8.54. **Pre-determined triggers for intervention in respect of client assets should be identified and where key risk indicators are included, these should be monitored.** A range of appropriate actions should be identified for each pre-determined trigger. Formal procedures, including sign-off, should be put in place for deviations from this approach.

Client Asset Review Committee ("CARC")

8.55. **A senior management committee, where serious client asset issues can be referred within a matter of hours should be established. This committee should also have standing quarterly meetings.**

8.56. Serious client asset issues, requiring immediate action, can arise suddenly. We recommend that a decision-taking committee, capable of being convened on a same-day basis, be established ("Emergency CARC"). The trigger-based approach should set out which interventions require approval of Emergency CARC. Voting members of Emergency CARC should comprise the following (or nominees):

- Deputy Governor – Financial Regulation (Chair);
- Markets Director;
- Consumer Protection Director; and
- Risk & Policy Director.

8.57. Non-voting attendees should include, at a minimum, the following (or nominees):

- Enforcement Director;
- Head of Legal;
- Head of CAST; and
- Head of Supervisory Division.

8.58. Given the potential gravity of decisions taken by Emergency CARC, it is recommended that an experienced, senior staff member be responsible for convening and minuting the decisions of Emergency CARC.

8.59. The approach proposed under Emergency CARC may have a wider application within the Central Bank.

8.60. CARC should also have standing quarterly meetings, which should review the sectoral risk maps, and discuss the general picture with respect to client assets.

8.61. We suggest that these meetings be chaired by the Markets Director, with other attendees including the following:

- Head of CPC – Investment & Insurance Intermediaries (or nominee);
- Head of Risk (or nominee);
- Head of CAST (or nominee);
- Head of ISPS (or nominee); and
- Head of MSSD (or nominee).

Client Asset Examination (CAE)

8.62. **A revised approach to the external auditor's report is recommended. There should be an annual review, or CAE, which would use CAMP as its starting point and would also ordinarily incorporate unannounced spot checks and external confirmations where appropriate. This should be underpinned by communication between the auditor and the Central Bank.**

8.63. Recognising the benefits of an independent external review of the firm's compliance with the rules we recommend an annual review of compliance with the CAR. This review should provide for unannounced spot checks and external confirmations from either banks or clients or both during the reporting period.

8.64. A more appropriate terminology is adopted for the process which fairly reflects what is required of the CAR audit and manages users expectations better, for example an independent third party examination, CAE on a firm's compliance with the CAR.

8.65. The proposed CAMP prepared by firms should be the starting point for the CAE. Based on the firm's assessment, the auditors would test that CAMP is up to date in terms of ensuring it has included changes such as new business, new risks and identified appropriate mitigants. Given this evidences a firm's compliance with CAR relative to its business model, the examination should be focused on testing a firm's compliance with its CAMP. We expect that auditors would report deficiencies or omissions in CAMP in addition to breaches of the CAR.

8.66. While there are elements of M47 which resonate with our proposals[74], in practice the focus of the guidance has been on the CAR compliance. We recommend that IAASA, together with the Central Bank prepare appropriate revised guidance.

8.67. Communication between auditors and the Central Bank is important. A mechanism should be in place for the Central Bank to discuss CAEs with external auditors. The current Auditor Protocol should be reviewed and adapted to the needs of firms holding clients assets.

Skilled Persons' Report

8.68. **We recommend that the Central Bank makes use of skilled persons' reports in its supervisory approach to client assets, in particular for very complex issues or in response to certain trigger events.**

8.69. The Central Bank's powers to appoint 'skilled persons' are included in the Central Bank (Supervision and Enforcement) Bill 2011 (as initiated). These powers will allow the Central Bank to require a firm to provide a report on a matter and for that person '*to have the skills necessary relating to the business of the reviewee to prepare an objective report on the matters concerned and, without prejudice to the generality of the foregoing, may be an auditor, actuary, accountant, lawyer or any other person with relevant business, technical or technological skills employed or otherwise engaged by the reviewee.'*

8.70. The use of skilled persons' reports should be compatible with CAST responsibilities and the risk-based approach for client assets, including monitoring of trigger events which may lead to the appointment of a skilled person. The Central Bank needs to develop protocols around the use of skilled persons' reports to encompass:

(a) the circumstances where a skilled persons' report is required;
(b) a case to be presented at an appropriate level of approval including cost/benefit analysis; and
(c) the process for determining the subject matter and drafting of engagement letters and the format of the report required.

Clearly, there is a cost to the firm associated with the preparation of a skilled persons' report and the benefits of any report need to be considered before a report is commissioned.

8.71. The area of client assets is specialised and can be very complex and there is a role for these skilled persons' reports to be used as an additional supervision tool where required, in particular, where it is suspected client assets are at risk and forensic skills need to be applied. Included within Section 7 is the Central Bank's recommendation as to the preparation of a CAMP by each firm subject to the CAR. There may be a role for skilled persons to review a firm's CAMP, depending on the impact of the firm or the complexity of its operations.

[74] For example, paragraphs 12, 17, 23 and 24 of M47

Enforcement

Background

8.72. Enforcement plays a fundamental role in achieving a credible regulatory regime. The stated aim of the Enforcement Directorate[75] is "to create an enforcement regime where the threat of enforcement action will be one that drives regulated entities towards the adoption of a proactive attitude towards compliance with financial services legislation and the ethics that underpin it". It is therefore an essential part of the regulatory tool kit, not least in the role it has to play in the safeguarding of client assets. This is particularly the case where the preponderance of firms handling client assets falls in to the low and medium low categories of PRISM, subject therefore to a lower intensity of supervision and where the threat of enforcement can enhance supervisory cover.

8.73. The Enforcement Directorate was established in June 2010 with a staff of approximately 20. The staff count has now expanded to 53 enforcement officers with an additional 14 devoted to anti-money laundering and financial sanctions work. In that period there have been two concluded administrative sanction cases for breaches of the CAR, both the subject of an agreed settlement[76] and one supervisory warning letter has been issued.

8.74. Enforcement actions fall into two broad categories – "Pre-defined" and "Reactive". Pre-defined enforcement derives from the work priorities of the supervisory divisions. Reactive enforcement relates to the enforcement actions deriving from other sources of information and events, both internal and external. Enforcement appetite and focus is intended to complement the priorities set out by the supervisory divisions to the extent that it is expected that up to 60% of targeted enforcement effort will come from this pre-defined category, with the balance made up of reactive enforcement cases.

8.75. Enforcement aligns its priorities with those themes identified by the supervisory divisions as being of the highest importance and concern and upon which they will concentrate their resource. In 2011 these included, among six stated priority areas, compliance with the CAR. In fact in 2011 only 25% of enforcement referrals originated from the pre-defined category (as opposed to the expected 60%) and only one of those was CAR related.

Observations

8.76. The experience thus far therefore has been that very few CAR cases have reached Enforcement, notwithstanding it has been a stated priority and invariably inspection teams identify breaches of the CAR. The reason for the low level of referrals by supervision to Enforcement is the perception as to the amount of time and resources it takes to bring an enforcement action to a conclusion and the lack of resources with which to do so. The supervisors have tended in the past therefore to use post inspection letters as the means of "warning" firms. The use of this informal warning process has more recently been discouraged and policy documents issued concerning the use of Supervisory Warning letters which are now issued through Enforcement. Given the options for calling firms to account in a formal way for breaches of the CAR are now routed through Enforcement, it

[75] Per Enforcement Strategy 2011 published in December 2010
[76] The Endowment Policy Purchasing Company Limited 11 November 2010 and Aviva Investors Ireland Limited 20 July 2011

is essential that, if enforcement action whether in the form of a supervisory letter or administrative sanctions is to be deployed effectively, there is good liaison between the two directorates.

8.77. The two cases which have been referred to the Enforcement Directorate since its formation, have taken eleven and eighteen months from the date of the referral to Enforcement to the conclusion of the settlement. This does not take account of the time taken from the date of inspection. We have not conducted a detailed review of the two cases which have been processed and we accept that the preparation of an enforcement case can involve evidential and technical complexities, but given that the breaches of these requirements are typically a matter of record, this appears to be an unduly prolonged process. The reason for such delays stems from:

(a) an unfamiliarity on the part of supervision as to what Enforcement requires to bring a case due perhaps to a lack of practical experience of working with Enforcement; and

(b) a shortage of resources to undertake the necessary forensic preparation and scrutiny of the case.

8.78. The issues are being addressed. The numbers in Enforcement have recently been substantially enhanced so that it is now capable of undertaking its own investigations. Also steps have been taken with the appointment of an Enforcement relationship manager assigned to each of the divisions in the Markets Directorate and the introduction of a case referral mechanism, to improve the alignment of the skills and resources of each of the Directorates.

Recommendation

8.79. **The effective implementation of these measures to improve the flow of referrals to Enforcement is essential. We believe the deployment of a specialist CAR (CAST) team utterly familiar with the regime, confident in its approach and working with Enforcement on a routine basis, will do much to achieve this.**

SUMMARY OF RECOMMENDATIONS

Objectives of the regime

9.1. Three principal objectives which should form the foundation of any client asset protection regime are:

- The maintenance of public confidence in the CAR regime;
- The mitigation of the risk of misuse of client assets whether as a result of maladministration or fraud; and
- The provision of a system which in the event of a firm's insolvency will enable the expeditious return of available client assets to the owner at lowest cost.

The Legislative Framework

Proposed Legislative Reforms

9.2. The Central Bank should be given a power to apply to the court for the appointment of an Administrator or a person with equivalent powers, to take charge of the affairs of an authorised firm where the Central Bank has reasonable grounds to suspect that:

(a) there are serious problems of a financial nature; and /or
(b) the interests of investors or clients of the firms are at risk.

9.3. Urgent consideration should now be given to a revision of the existing insolvency provisions in line with the pre-determined distribution rules proposed by the ICCL but any revisions take account of relevant developments elsewhere in particular the UK's Special Administrator Regime for investment firms.

CAR

The Form of the CAR

9.4. The presentation of the CAR should be revised:

(a) making greater use of higher level principles reinforced with appropriate guidance so as to introduce greater flexibility into the regime and a more accessible explanation of the rationale of the underlying rules; and
(b) setting out the rules in a way which avoids unnecessary and potentially contradictory statements and lends itself to more effective compliance.

The Scope of the CAR

9.5. The CAR be amended to provide a clear and consistent definition of client assets. The wider definition of client assets should be adopted so that the presumption in the requirements is that all client funds received or held by an authorised entity be subject to the CAR regardless of the intended investment.

9.6. A practicable and relevant regime, which draws on best practice, should be developed specific to the operation of DDA accounts. This should be progressed in consultation with the FSPs.

The Substance of the CAR

9.7. We recommend:
(a) that the daily calculation remain a daily requirement;
(b) the purpose of the provision is made clear, i.e. to create a buffer to cover any deficiencies on the account which may arise as an inevitable consequence of the way in which the account is operated; and
(c) that the formula used to calculate the size of the buffer is revised so as to deliver a safeguard appropriate to the business model of the firm.

9.8. The CAR is revised taking account of the points raised from paragraphs 6.21 to 6.24 and also having regard to the presentation of the client facing obligations on firms. This is not an exhaustive list.

9.9. To facilitate the development of a revised and improved CAR a joint working group of the Central Bank and Industry be established to develop detailed proposals.

Regulatory Structure

Authorisations

9.10. An application by a firm to hold client assets should be considered more holistically, using risk-based techniques so that the range of the firm's activities, its governance and processes can be fully assessed.

9.11. All authorisations to hold client assets should require sign-off from Central Bank specialists, which would include a review of the applicant's own arrangements for safeguarding of client assets.

9.12. Authorisation to hold client assets should trigger consideration of additional corporate governance and internal controls requirements, such as a requirement to have an internal audit function, a requirement to have segregated compliance and risk functions and a requirement for two independent non-executive directors.

9.13. Where authorisation to hold client assets is granted, unregulated business should not exceed 10% of turnover.

9.14. The registers of firms should disclose which firms have authorisation to hold client assets.

9.15. For newly authorised firms, authorisation information, including a copy of the memorandum of recommendation and the letter of authorisation, should be copied to CPC. In addition representatives from CPC should attend handover meetings for newly authorised firms.

PCF

9.16. A Client Assets PCF be introduced for all firms which hold or intend to hold client assets. The PCF should have overall responsibility to the firm's governing body and to the Central Bank for oversight of client assets within the firm. The PCF and the board as a whole would also be responsible for sign-off on the firm's CAMP. The guidance issued by the Central Bank regarding the approval for PCFs should be followed. A risk-based approach should be adopted in deciding whether these PCFs would be called for interview by the Central Bank.

CAMP

9.17. A firm holding client assets should prepare a CAMP. This would assist the Client Assets PCF in their role. It should also assist the work of CAST in not only enabling appropriate risk-based monitoring of individual firms, but to assist in peer review and systematic risk identification when used in conjunction with the other information available to the Central Bank.

Consumer Awareness

9.18. The Central Bank should engage with the NCA to highlight key factors for consumers to consider in order to understand the risks and make informed decisions.

The Supervisory Approach

9.19. A CAST with cross-sectoral ownership for client asset risk should be established. CAST should liaise closely with primary supervisors and should report directly to the Markets Director.

9.20. Effective use of CAST resourcing requires a risk-based approach which dovetails with the opportunities presented by PRISM. It should allow additional differentiation of risk between firms holding client assets, above and beyond the risk differentiation within PRISM.

9.21. Pre-determined triggers for intervention in respect of client assets should be identified and where key risk indicators are included, these should be monitored.

9.22. A senior management committee (CARC), where serious client asset issues can be referred within a matter of hours should be established. This committee should also have standing quarterly meetings.

9.23. There should be a revised approach to the external auditor's report. There should be an annual review, or CAE, which would use CAMP as its starting point and would also ordinarily incorporate unannounced spot checks and external confirmations where appropriate. This should be underpinned by communication between the auditor and the Central Bank.

9.24. The Central Bank should make use of skilled persons' reports in its supervisory approach to client assets, in particular for very complex issues or in response to certain trigger events.

Enforcement

9.25. CAST should work with Enforcement on a routine basis to improve the flow of referrals to Enforcement.

SUGGESTIONS AS TO NEXT STEPS

10.1. Our recommendations are extensive and encompass a number of different areas. It is likely that a number of stakeholders, both internal and external, will need to be closely involved in the implementation of these recommendations. Therefore it appears to us that the implementation phase needs careful consideration and planning with resources dedicated to this task. In addition, it needs to have the appropriate level of prioritisation attached to it, to ensure that recommendations are put in place as speedily as possible.

10.2. Where consultation with the industry is required or is desirable, we recommend that this process is initiated as soon as possible. Where engagement with the Department of Finance is in process, we encourage early enactment of our proposals with regard to legislative changes. Certain recommendations, particularly those relating to internal structure, lend themselves to quick adoption.

10.3. When implementation is completed and the changes have been in operation for a year or so, we think it would be useful for Internal Audit to review how the regime is working in practice.

10.4. We suggest that responsibility for the implementation of this report is assigned to the Deputy Governor (Financial Regulation).

APPENDICES

Appendix I

TERMS OF REFERENCE

Having regard to (a) the roll-out of the Central Bank's Supervisory Risk Model (PRISM), (b) rules and regulations in place to safeguard client assets and, with the benefit of hindsight, the operation of such leading up to the appointment of court inspectors in relation to CHC, (c) the current review of the Central Bank's CAR for MiFID and IIA firms and (d) international reviews of rules for holding client money, including the current review of MiFID, the Central Bank has commissioned a Task Force (known as the 'Client Assets Task Force') to review various aspects of the scope and oversight of regulated firms' client asset arrangements.

This Task Force will produce a report and make recommendations to the Deputy Governor, Financial Regulation, on the following matters:

1. The scope of the regulatory regime as regards the safeguarding of client assets by reference to (a) asset types, (b) investment activities and (c) types of firms and the extent to which regulated firms may hold assets of customers which are unregulated investments and therefore not subject to client asset requirements.

2. The adequacy of Central Bank supervisory arrangements for client assets and, where relevant, the linkages to the arrangements for the supervision of Conduct of Business, including:
   (a) the sufficiency of the existing rules and regulations to safeguard client assets;
   (b) the skills, resources, approach and legal powers needed to assess firms' client asset arrangements, including an assessment of whether Central Bank inspectors have sufficient legal powers to verify client assets with custodians and/or deposit-takers; and
   (c) the supervisory arrangements, skills and resources required to investigate cases of suspected or reported misuse of client assets;

3. The adequacy and implementation of current guidelines for independent audits of client assets, including:

   a) the degree to which reliance should be placed on regular independent audits of client assets (especially for firms with limited direct supervisory interaction (low and medium low impact firms)) under PRISM;
   b) the guidance set out in M47 issued by the Institute of Chartered Accountants;
   c) the extent to which audit firms can conduct this work in conjunction with the audit of financial statements;
   d) the skills and resources needed to audit firms' client asset arrangements;
   e) the scope, depth and frequency of such audits;
   f) the extent to which the guidelines make provision for the detection of fraud and deception relating to the misuse of client assets; and
   g) the extent to which independent auditors could be held accountable or liable for errors in such reports were failures in client asset arrangements to be subsequently found.

4. The potential for the use of 'skilled persons' reports to supplement regular audits and the Central Bank's own supervisory tools and the extent to which 'skilled persons' could be held accountable or liable for errors in such reports were failures in client asset arrangements to be subsequently found.

5. The viability of a graded process of client asset assessments/audits which might be implemented depending on the amount of client assets held by a firm and/or the degree of concern/suspicion of a regulated firm's handling of client assets.

6. Any shortfall between the safeguards recommended by the Task Force and the scope of regulations for investment firms and trustees or anticipated revisions to the same as a consequence of the planned MiFID and UCITS directives on client asset requirements.

Governance

The report and recommendations to be made to the Deputy Governor and also made available to the Chairman of the Audit Committee of the Commission of the Central Bank of Ireland.

Resources

The review will be led jointly by Risk Advisers Andrea Pack and James Bagge. They will be supported by a team of dedicated Central Bank staff.

Reporting

The Task Force will provide fortnightly updates to the Deputy Governor (Financial Regulation).

Appendix II

MiFID Investment Services & Financial Instruments

Investment Services

1. Reception and transmission of orders in relation to one or more financial instruments.
2. Execution of orders on behalf of clients.
3. Dealing on own account, meaning the activity of trading against proprietary capital resulting in the conclusion of transactions in one or more financial instruments.
4. Portfolio management.
5. Investment advice.
6. Underwriting of financial instruments or placing of financial instruments on a firm commitment basis.
7. Placing of financial instruments without a firm commitment basis.
8. Operation of multilateral trading facilities.

Financial Instruments

1. Transferable securities.
2. Money market instruments.
3. Units or shares in undertakings for collective investment in transferable securities within the meaning of the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 1989 (S.I. No. 78 of 1989).
4. Units in a unit trust.
5. Shares in an investment company.
6. Capital contributions to an investment limited partnership.
7. Units in a common contractual fund.
8. Options, futures, swaps, forward rate agreements and any other derivative contracts relating to any of the following:

> (a) securities, currencies, interest rates or yields, or other derivative instruments, financial indices or financial measures which may be settled physically or in cash;
> (b) commodities that must be settled in cash or may be settled in cash at the option of one of the parties (otherwise than by reason of a default or other termination event);
> (c) commodities that can be physically settled, provided that they are traded on a regulated market or on an MTF;
> (d) commodities, other than as described in clause (iii), and not being for commercial purposes, if the commodities can be physically settled and have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are cleared and settled through recognized clearing houses or are subject to regular margin calls;
> (e) climatic variables, freight rates, emission allowances or inflation rates or other official economic statistics if the options, futures, swaps, forward rate agreements or other derivative contracts, as the case may be, must be settled in cash or may be settled in cash at the option of one of the parties (otherwise that by reason of a default or other termination event).

9. Derivative instruments for the transfer of credit risk.
10. Financial contracts for differences.

11. Other derivative instruments relating to assets, rights, obligations, indices and measures not otherwise mentioned in this definition if the derivative instruments have the characteristics of other derivative financial instruments, having regard to whether, inter alia, they are -

(a) traded on a regulated market or an MTF,

(b) cleared and settled through recognised clearing houses, or

(c) subject to regular margin calls.

Appendix III
IIA Investment Business Services & Investment Instruments

Investment Business Services:
(a) receiving and transmitting, on behalf of investors, of orders in relation to one or more investment instrument;

(b) execution of orders in relation to one or more investment instrument, other than for own account;

(c) dealing in one or more investment instrument for own account;

(d) managing portfolios of investment instruments or deposits in accordance with mandates given by investors on a discretionary client-by-client basis where such portfolios include one or more investment instrument or one or more deposit;

(e) underwriting in respect of issues of one or more investment instrument or the placing of such issues or both;

(f) acting as a deposit agent or deposit broker;

(g) the administration of collective investment schemes, including the performance of valuation services or fund accounting services or acting as transfer agents or registration agents for such funds;

(h) custodial operations involving the safekeeping and administration of investment instruments;

(i) acting as a manager of a designated investment fund within the meaning of the Designated Investment Funds Act, 1985.

"investment instruments" includes-

(a) transferable securities including shares, warrants, debentures including debenture stock, loan stock, bonds, certificates of deposits and other instruments creating or acknowledging indebtedness issued by or on behalf of any body corporate or mutual body, government and public securities, including loan stock, bonds and other instruments creating or acknowledging indebtedness issued by or on behalf of a government, local authority or public authority, bonds or other instruments creating or acknowledging indebtedness, certificates representing securities, or money market instruments,

(b) non-transferable securities creating or acknowledging indebtedness issued by or on behalf of a government, local authority or public authority,

(c) units or shares in undertakings for collective investment in transferable securities within the meaning of European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 1989 (S.I. No. 78 of 1989), and any subsequent amendments thereto, units in a unit trust, shares in an investment company, capital contributions to an investment limited partnership,

(d) financial futures contracts, including currency futures, interest rate futures, bond futures, share index futures and comparable contracts,

(e) commodity futures contracts,

(f) forward interest rate agreements,

(g) agreements to exchange payments based on movements in interest rates, currency exchange rates, commodities, share indices and other investment instruments,

(h) sale and repurchase and reverse repurchase agreements involving transferable securities,

(i) agreements for the borrowing and lending of transferable securities,

(j) certificates or other instruments which confer all or any of the following rights, namely-

(i) property rights in respect of any investment instrument referred to in paragraph (a) of this definition; or

(ii) any right to acquire, dispose of, underwrite or convert an investment instrument, being a right to which the holder would be entitled if he held any such investment to which the certificate or instrument relates; or

(iii) a contractual right (other than an option) to acquire any such investment instrument otherwise than by subscription,

(jj) a rolling spot foreign exchange contract,

(k) options including-

(i) options in any instrument in paragraphs (a) to (j) of this definition, or

(ii) currency, interest rate, commodity and stock options including index option contracts,

(kk) a tracker bond or similar instrument,

(l) hybrid instruments involving two or more investment instruments,

(m) insurance policies;

(n)Personal Retirement Savings Accounts within the meaning of Part X of the Pensions Act, 1990;

and includes any investment instrument in dematerialised form, but this definition shall not be construed as applying to-

(I) any instrument acknowledging or creating indebtedness for, or for money borrowed to defray, the consideration payable under a contract for the supply of goods or services; or

(II) a cheque or other similar bill of exchange, a banker's draft or a letter of credit; or

(III) a banknote, a statement showing a balance in a current, deposit or savings account or (by reason of any financial obligation contained in it) to a lease or other disposition of property **. . .**;

Appendix IV

Article 4 of Directive 2006/74/EC, implementing Directive 2004/39/EC

Additional requirements on investment firms in certain cases

1. 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 one of the following conditions is met:

> (a) the specific risks addressed by the requirements are of particular importance in the circumstances of the market structure of that Member State;
> (b) the requirement addresses risks or issues that emerge or become evident after the date of application of this Directive and that are not otherwise regulated by or under Community measures.

2. Any requirements imposed under paragraph 1 shall not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC.

3. Member States shall notify to the Commission:

> (a) any requirement which it intends to retain in accordance with paragraph 1 before the date of transposition of this Directive; and
> (b) any requirement which it intends to impose in accordance with paragraph 1 at least one month before the date appointed for that requirement to come into force.

In each case, the notification shall include a justification for that requirement. The Commission shall communicate to Member States and make public on its website the notifications it receives in accordance with this paragraph.

4. By 31 December 2009 the Commission shall report to the European Parliament and the Council on the application of this Article.

Appendix V
Forthcoming EU Developments

MiFID II

Other proposals which may impact client assets are:

- Possible classification of the safekeeping of financial instruments on behalf of clients as an investment service; and
- Inclusion of the sale of structured deposits by credit institutions in the scope of MiFID activities.

AIFMD

The most relevant of the current proposals for depositaries include:

- safe keep the Alternative Investment Fund (AIF)'s assets and oversee compliance with the AIF's rules and instruments of incorporation and with applicable law and regulation;
- ensure the cash flows of the AIF are properly monitored. The duty to safe keep will depend on the type of asset held by the AIF and consists of custody or of record-keeping;
- be aware of all cash flows (not just the AIF subscription and redemption accounts) and all bank accounts opened at third parties;
- monitor the cash flows and look into the reconciliation procedures as well as being required to ensure that payments made by investors have been received by the AIF;
- require that a third party that acts as a delegate to the depositary must appropriately segregate and separately identify any assets as held for the client;
- defines what constitutes a loss of financial instrument and whether there was an external event causing the loss which was beyond the control of the depositary, the consequences of which would have been unavoidable despite reasonable efforts; and
- There are also proposals regarding when financial instruments are considered lost following the insolvency of a sub-custodian.

Appendix VI
Delivering Risk Based Supervision through PRISM

PRISM

In November 2011, the Central Bank launched PRISM (Probability Risk and Impact SysteM) to enhance our ability to deliver judgement-based, outcome-focused regulation. PRISM gives the Central Bank a unified and much more systematic risk-based framework – making it easier for our banking and insurance supervisors to challenge the financial firms they regulate, judge the risks therein and take action to mitigate those risks – securing meaningful change on behalf of consumers, citizens and the State.

What is risk-based supervision?

Risk-based supervision starts with the premise that not all firms are equally important to the economy and that a regulator can deliver most value through focusing its energies on the firms which are most significant and on the risks that pose the greatest threat to financial stability and consumers. A risk-based system will also provide a systematic and structured means of assessing different types of risk, ensuring that idiosyncratic approaches to firm supervision are avoided and that potential risks are analysed for the higher impact firms using a common framework. This will allow judgements about potential risk in different firms to be made using a common risk typology on a common scale.

PRISM is the vehicle that we have developed to put the theory of risk-based supervision into practice. It is designed to be implemented by a few hundred supervisors on several thousand regulated firms. PRISM is both a supervisory tool and a software application.

PRISM is designed to allow us to:-

- adopt a consistent way of thinking about risk across all supervised firms;
- allocate resources based on impact and probability;
- undertake a sufficient level of engagement with all higher impact firms;
- assess firm risks in a systematic and structured fashion;
- ensure that action is taken to mitigate unacceptable risks in firms;
- provide firms with clarity around our view of the risks they pose;
- operate a risk-based supervisory framework similar to that operated by significant financial regulators such as OSFI[77] in Canada, APRA[78] in Australia, the US Federal Reserve, De Nederlandsche Bank[79], and the new Prudential Regulation Authority in the UK;
- use quality control mechanisms to encourage challenge and sharpen our supervisory approach; and
- analyse better management information about the risk profiles of the firms and sectors we supervise.

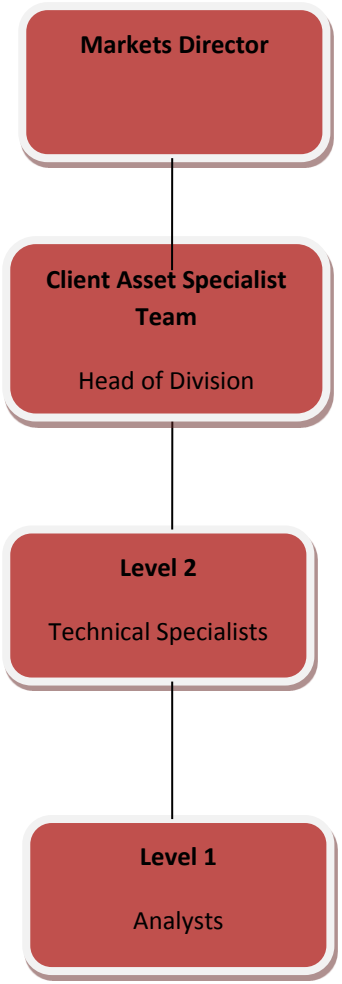
Under PRISM, the most significant firms - those with the ability to have the greatest impact on financial stability and the consumer - will receive a high level of supervision under structured engagement plans, leading to early interventions to mitigate potential risks. Conversely, those firms which have the lowest potential adverse impact will be supervised reactively or through thematic assessments, with the Central Bank taking targeted enforcement action against firms across all impact categories whose poor behaviour risks jeopardising our statutory objectives including financial stability and consumer protection.

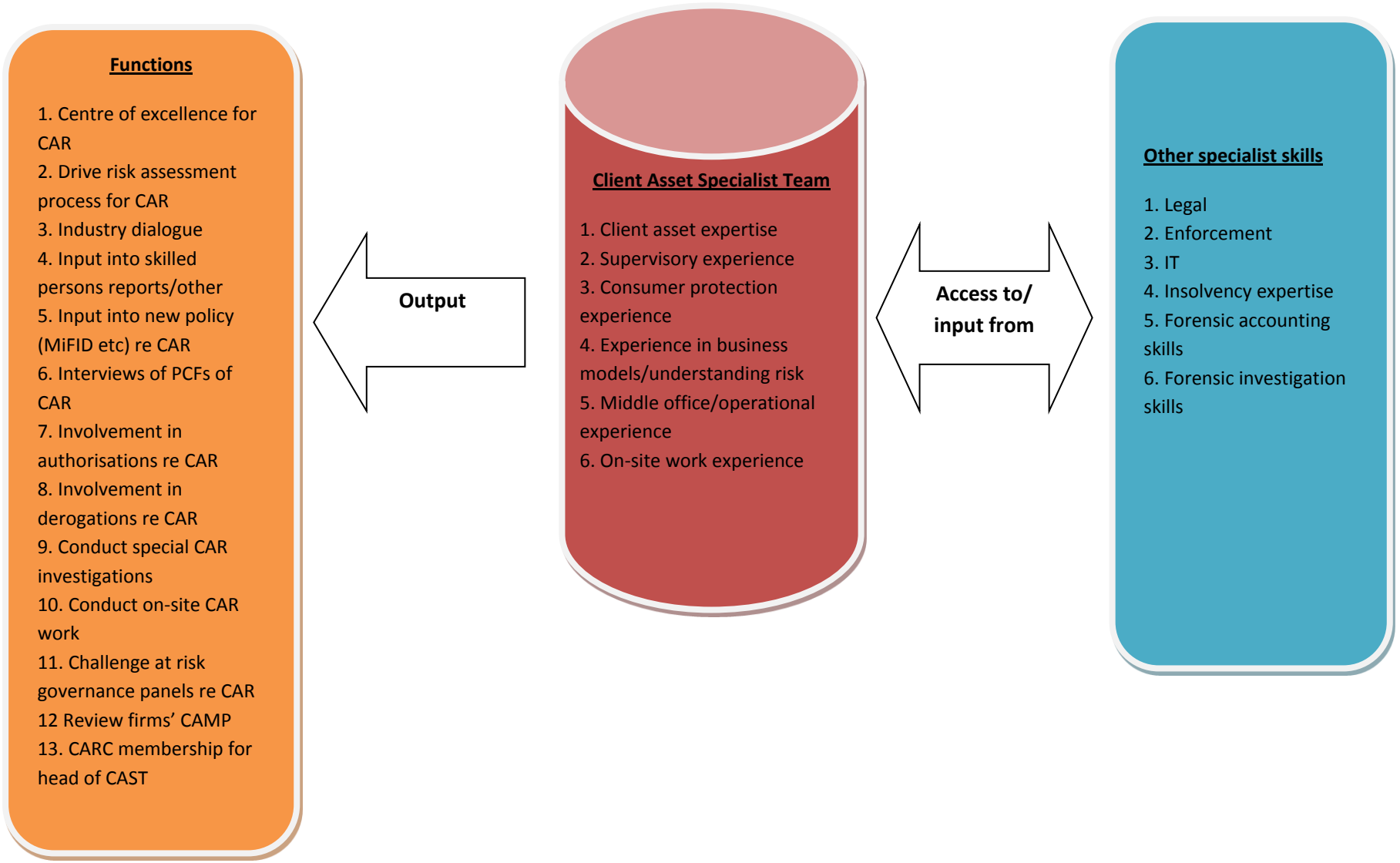
[77] The Office of the Superintendent of Financial Institutions
[78] Australian Prudential Regulation Authority
[79] The prudential financial services regulator in the Netherlands

During 2012 we will roll out PRISM to supervisors responsible for investment firms, credit unions and financial intermediaries. At the same time, we will introduce improvements to the functionality of the PRISM software application. We will also encourage best practice through risk governance panels which quality assure supervisory outputs, particularly in relation to High and Medium-high Impact Firms and through the development of a new supervisory support team which will, among other things, support supervisors across all supervisory areas in the development of best practice approaches to supervision.

Appendix VII

Resourcing model for CAST




Functions
1. Centre of excellence for CAR
2. Drive risk assessment process for CAR
3. Industry dialogue
4. Input into skilled persons reports/other
5. Input into new policy (MiFID etc) re CAR
6. Interviews of PCFs of CAR
7. Involvement in authorisations re CAR
8. Involvement in derogations re CAR
9. Conduct special CAR investigations
10. Conduct on-site CAR work
11. Challenge at risk governance panels re CAR
12 Review firms' CAMP
13. CARC membership for head of CAST
Output
Client Asset Specialist Team
1. Client asset expertise
2. Supervisory experience
3. Consumer protection experience
4. Experience in business models/understanding risk
5. Middle office/operational experience
6. On-site work experience
Access to/ input from
Other specialist skills
1. Legal
2. Enforcement
3. IT
4. Insolvency expertise
5. Forensic accounting skills
6. Forensic investigation skills

Appendix VIII
Risk-based supervision, supplementary to PRISM

This is the model which applies on a business-as-usual basis. Where a trigger event occurs, regulatory interventions in line with a trigger-based approach are required. For firms holding client assets, risk is measured on a relative basis.

This table is an illustrative example of the engagement tasks under the business-as-usual approach.

Engagement Task	Routine	Enhanced
Review of CAMP	On receipt of update	On receipt of update
Meeting with PCF & external auditor	Annual	Annual
Review of CAE	Annual	Annual
Update risk assessment, including review of client asset returns	Annual	Annual
Thematic inspection	At least once every four years	At least once every two years

Risk Scoring

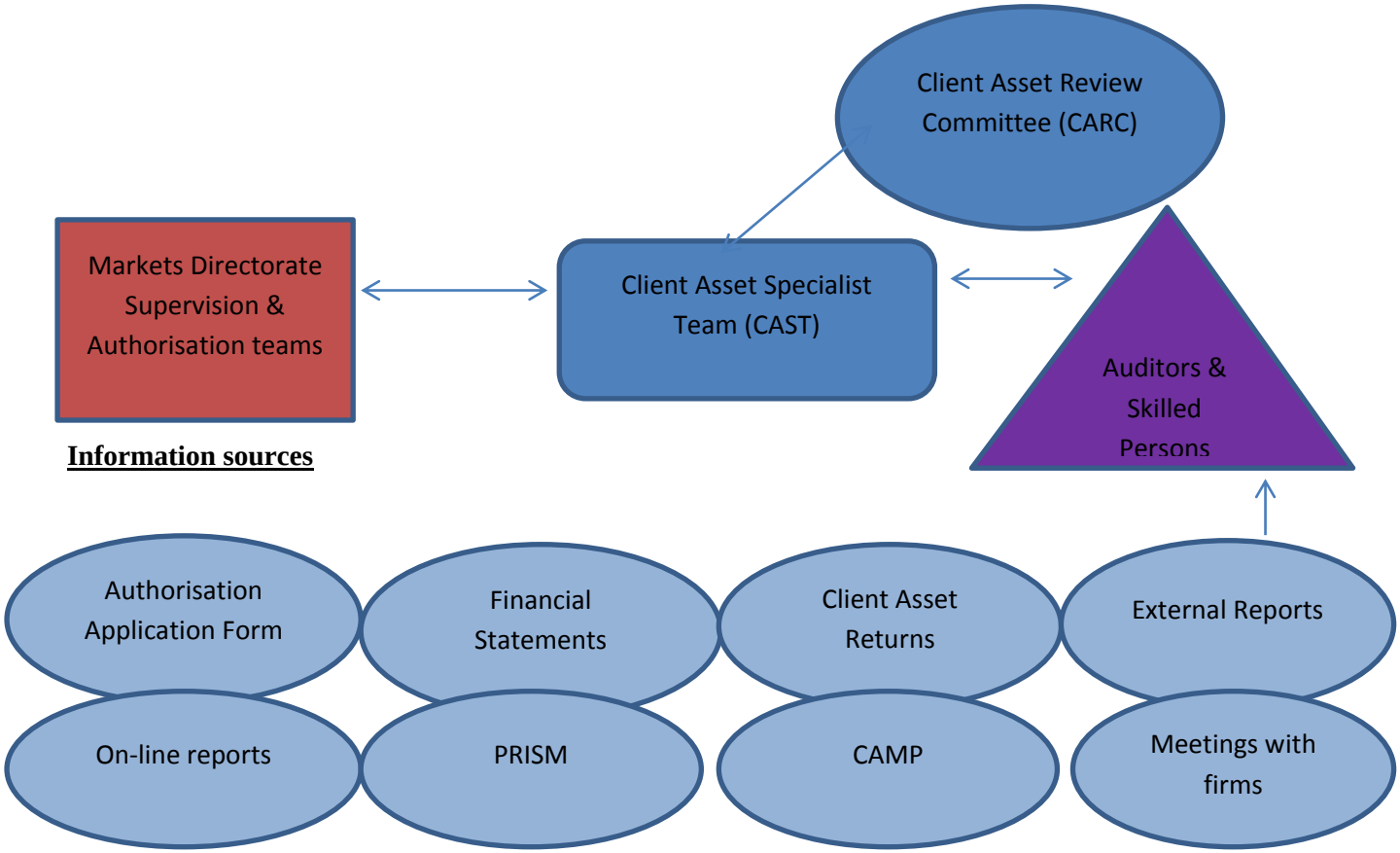
A risk scoring framework specific to client assets, leveraging off the broad risk-scoring under PRISM, should be developed. An illustration of the types of key risk indicators and relative weightings which may form part of this framework is listed below.

1. Scale of operations/systemic factors – 40%
    a. PRISM impact category
    b. Number of clients
    c. Value of client money held
    d. Value of client assets held
    e. Name of counterparties, with values held at each, to identify concentration risk
2. Ownership/governance – 20%
    a. Is company owner managed?
    b. Quality of senior management including directors, particularly independent non-executive directors
    c. Is capacity to raise new capital limited?
    d. Is there an internal audit function?
    e. Is there effective segregation of front & back-office?
    f. Is there effective segregation of compliance and finance?
    g. Is there a history of compliance issues?
    h. Quality of external auditors
3. Complexity of operations – 20%
    a. Is the firm a proprietary trader?
    b. Does unregulated business account for >10% of turnover?
    c. Type of clients
    d. Do retail clients account for >30% of total clients?
    e. Number of different products/services offered
    f. Number of counterparties/sub-custodians and number of different jurisdictions in which they are located

    g. Is the firm part of a group and does it place client assets within that group network?
    h. Are there outsourcing arrangements in place?
4. Capital position – 25%
    a. Surplus capital ratio
    b. Profitability trends, period of time current losses can be absorbed
    c. Liquidity

APPENDIX IX

Client Asset Supervisory Approach



GLOSSARY OF TERMS

AIF	Alternative Investment Fund
AIFMD	Alternative Investment Fund Managers Directive
APB	Auditing Practices Board
ARF	Approved Retirement Fund, a post retirement investment fund into which certain retirees can invest their pension savings
Bank of America	Bank of America Custodial Services Ireland Limited
CAE	Client Assets Examination
CAMP	Client Assets Management Plan
CAR	Client Asset Requirements issued under S.I. No. 60 of 2007 European Communities (Markets in Financial Instruments) Regulations 2007
CARC	Client Assets Review Committee
CASS	Client Asset Sourcebook issued by the FSA
CAST	Client Assets Specialist Team
Central Bank	the Central Bank of Ireland
CEO	Chief Executive Officer
CF10a	FSA Contolled Function for Client Assets
CHC	Custom House Capital
CHC Property	the property fund offered by CHC
CHC1	sub-fund operated by CHC
CHC2	sub-fund operated by CHC
CIS	Collective Investment Scheme
Client assets	consist of client monies and client financial instruments.

Client financial instruments	consist of financial instruments which, in the course of carrying on investment business a firm receives or holds for, or on behalf of, clients.
Client monies	as defined by CAR are cash, cheques or other payable orders together with client accounts maintained with a central bank, an eligible credit institution or a qualifying money market fund and include current and deposit accounts maintained with eligible credit institutions.
Consumer Protection Code	originally introduced by the Central Bank in August 2006, most recently revised and reissued on 1 January 2012
CPC	Consumer Protection Codes Directorate
CRD	Capital Requirements Directive
DDA accounts	subscription/redemptions accounts operated by FSPs
EUT	the exempt unit trust or Destiny product offered by CHC (in Custom House Capital Limited section only)
Exempt unit trust	a collective investment scheme which is exempt from tax on its income and gains and which falls outside the scope of the Unit Trust Act 1990.
FASD	Funds Authorisation & Supervision Division
FSA	Financial Services Authority of the UK
FSPs	Fund Service Providers, being trustees and administration companies
GAAP	Governance, Auditing and Accounting Policy Division
IAASA	Irish Auditing & Accounting Supervisory Authority
ICCL	Investor Compensation Company Limited
ICD	Investor Compensation Directive
IIA	Investment Intermediaries Act 1995
Inspectors	Court Inspectors (in Custom House Capital Limited section only)
Investment Firm	under MiFID is defined as any person, with certain exceptions, whose regular occupation or business is the provision of one or more investment services to third parties on a professional basis.

ISA	International Standards on Auditing
ISPS	Investment Service Providers Supervision Division
LBIE	Lehman Brothers International Europe, UK subsidiary of Lehmans
MBF	the Mezzanine Bond Fund offered by CHC
MiFID	Markets in Financial Instruments Directive
MiFID Regulations	the European Communities (Markets in Financial Instruments) Regulations 2007 (S.I. 60 of 2007)
MiFID II	EU proposals for a revised MiFID Directive
MCR	Minimum Competency Requirements originally introduced by the Central Bank on 1 January 2007 and most recently revised and reissued on 1 December 2011.
Morrogh	W&R Morrogh Stockbrokers
MSSD	Markets & Stockbrokers Supervision Division
M47	Miscellaneous Technical Statement 47
NAV	Net Asset Value
NCA	National Consumer Agency
NED	non-executive Director
Non-UCITS	a category of Irish CIS introduced under the Unit Trust Act 1990 and Part XII of the Companies Act 1990
PCF	Pre-approval Controlled Function, as set out in the Central Bank's Fitness and Probity Regime
PRISM	Probability Risk and Impact System, the Central Bank's risk-based framework
PRSA	Personal Retirement Savings Account, type of personal pensions contract introduced in 2003.
PSD Regulations	the European Communities (Payment Services) Regulations 2009
QIF	Qualifying Investor Funds, a type of non-UCITS fund, only open to investors that meet the eligibility criteria and make an initial subscription in excess of a set minimum.

SPV	Special Purpose Vehicle
Task Force	the Client Asset Task Force
UCITS	Undertaking in Collective Investment for Transferable Securities subject to the UCITS directive
UCITS IV	Changes to UCITS effective from 1 July 2011
2011 Act	Central Bank and Credit Institutions (Resolution) Act 2011