

Funds industry faces client asset reform

Consultation Paper 71

The changes proposed in the Central Bank of Ireland's consultation on client assets are likely to impact the funds industry. CP 71 proposes to develop a new regime for collection accounts operated by fund service providers as early as Q1 2014. Given the possible effect on daily processes and the high level of oversight afforded to client assets generally, it is important that firms understand the requirements now so that they can analyse the impact and take appropriate action. Unravelling the new requirements from a contractual and technical perspective will take time. Alternatively, fund service providers may seek to adopt structures to remain out of scope. This carries both regulatory risk and the risk that many of these arrangements have yet to be tested by an insolvency situation.



Current situation

Ireland's existing client asset requirements (CAR) apply to firms that in the course of carrying out an investment business, "receive, hold or pay out" monies for or on behalf of clients. On the face of it, the CAR therefore apply to transfer agency activities in respect of subscriptions and redemptions, involving the transfer of monies to and from the fund through collection accounts. However, the "one size fits all" approach of the CAR posed many practical challenges in applying client asset rules to third party fund service providers.



Many fund service providers would consider that their client relationship is with the fund manager rather than the end investor, as the investor contracts directly with the fund manager. In such a situation the Central Bank has taken the view that the fund administrator's role is "solely in relation to the processing of documentation passed to it by the manager". Relying on this and other restructuring and/or disclosure techniques, a large number of fund administrators have been able to satisfy themselves that they sit outside the CAR.

Treatment of collection accounts

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The treatment of collection accounts has been an area of ongoing concern for the Central Bank of Ireland for some time. In a review published in March 2012, reviewers appointed by the Central Bank articulated their view that monies passing through collection accounts are client assets within scope but acknowledged that for practical reasons that CAR are not applied to the operation of these accounts. The report stated: "We regard this lacuna as unsatisfactory. It is undesirable that no appropriate requirements to safeguard client assets are imposed at this stage of the process. This should be resolved."

Under the CP71 and the accompanying draft regulations, the Central Bank proposes to develop a "proportionate regime" to address this "lacuna". The CAR would apply to client money deposited in the collection account. When monies are transferred to the investment fund, the CAR would no longer apply. Likewise, the CAR will apply when the funds flow back from the investment fund to the fund service provider and are deposited into the collection account for onward transmission to the client. This would apply in the case of the redemption of the fund or where a fund pays dividends.

Core principles

For firms subject to the CAR, CP71 proposes sweeping changes representing a very significant increase in oversight, due diligence, reconciliation and documentation. The Central Bank introduces the concept of "Core Principals" which include:

- Segregation
- Designation and registration
- Reconciliation
- Daily calculation
- Client disclosure and client consent
- Risk management
- Client asset examination

Fund service providers subject to the CAR will need to apply these principles to collection accounts. This represents a very significant change to the current operation of collection accounts, requiring detailed new processes to maintain the required level of identification, segregation, reconciliation and oversight. As with any form of principals based regulation, significant effort will be required in demonstrating how a firm's processes and procedures are in line with the principals.

Segregation within pooled accounts

Accounting segregation must be maintained where client assets are pooled in a collection account. In its internal records, the firm must maintain detailed and accurate records in order to identify how much each



client holds in that pooled client asset account/collection account and movements in that balance.

This means that if pooled collection accounts are held with a number of third parties, a firm must be in a position to identify which client assets are held in each pooled account with each third party for each individual client.

Reconciliation and transfers

A fund service provider must reconcile the collection account each day that a transaction occurs on that account, but in any event, at least monthly and such reconciliation must be carried out by the end of the following business day to which the reconciliation relates. Where a fund service provider transfers funds from the collection account to an investment fund prior to receiving such funds into the collection account from the client, it will result in a deficit in the collection account. The service provider should ensure that any credit balances available in the collection account are not used to fund or reduce this deficit. Prior to operating in this manner, the service provider should ensure that it has a credit facility in place to finance such deficits or it operates a separate collection account for credit balances. Where a credit facility exists, the service provider should ensure that such credit facility does not attach a lien/charge over the client assets.

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Client communication

Each time a fund service provider receives client funds, it must, as soon as practical, issue to the client a receipt in writing for those funds and include at a minimum:

- the date on which the client funds will be transferred out to the investment fund; and
- information that the CAR regulations will apply to the client funds in the collection account but will cease to apply when the client money is transferred to the investment fund.

A fund service provider must obtain the client's consent in writing in the investment fund's application form in situations:

- where client assets are to be passed to other persons other than the investment fund;
- when client assets are held in a pooled collection account;
- where interest earned on client funds is to be retained by the FSP.

Fund service providers must provide a 'Client Asset Key Information Document' ("CAKID") to all clients. The CAKID may be attached to the investment fund's application form for new clients. The service provider must document how it will supply the CAKID to existing clients.

Oversight and client assets management plan (CAMP)

Each firm subject to the rules must appoint a Client Asset Oversight Officer (CAOR) to maintain responsibility of client assets. This person would be a pre-approved controlled function appointed under Part 3 of the Central Bank Reform Act 2010. This means, amongst other things, that the designated person must demonstrate they have the competence to perform in that function. A detailed knowledge of the CAR must be a substantial element of demonstrating such competence.



A function of this role will be the development of a Client Assets Management Plan (CAMP), which must be approved by the board and reviewed at least annually. The key purpose of the CAMP is to:

- demonstrate how the firm's systems and controls meet the objectives of the client assets regime;
- document the firm's business model and related risks in respect of the safeguarding of client assets and the controls in place to mitigate these;
- enable the board to document and monitor material changes to the firm's business model, changes to controls and processes and therefore the changes in the associated risks to the safeguarding client assets;
- make information readily available to assist in the prompt distribution of client assets in the event of the firm's insolvency.

Auditor obligations

Within three months of the new CAR taking effect, a firm must obtain an independent assessment of its Client Assets Management Plan.

The regulations require the auditor to report annually on the firm's safeguarding of client assets, indicating the adequacy of processes and systems and the level of compliance the new regulations.

In addition, the Central Bank expects that a firm would instruct the auditor at a minimum to seek:

1. external confirmations of any balances held in respect of client assets by other financial institutions both at year-end and also on one other randomly scheduled date during the year; and
2. positive confirmation requests, from a representative sample of clients as determined by the auditor, of client asset balances at the randomly selected date during the year, not to be the period end date.

CAMP review

Within three months from the date of the taking effect of the new regulations, a firm must obtain an assessment of the CAMP from an independent external expert (not being the firm's external auditor). The review will assess:

- whether the CAMP has been drafted in sufficient detail to capture the operational risks;
- whether the controls identified within the CAMP have been implemented in a manner consistent with that documented within the CAMP;
- whether the CAMP adequately covers all of the requirements that need to be captured;
- the identification of areas where, in the opinion of the external expert, the CAMP could be improved;
- the appropriateness of the firm's ongoing controls process.



Preparing for reform

The proposed rules represent a significant change in practice for the vast majority of fund service providers. Fund service providers need to fully understand the requirements now so that they can analyse the impact and contribute to the outcome of the consultation process. Firms have until 31 October 2013 to respond to the consultation. While the outcome is uncertain, we expect that the Central Bank will take a firm stance on the application of the CAR to collection accounts.

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Industry proposals have focused on structuring collection accounts as custody assets of the investment fund in line with AIFMD, with the effect that the CAR would no longer apply. These proposals seek to reflect the AIFMD and the proposed UCITS V model by applying the cash monitoring and reconciliation duties to collection accounts. In line with AIFMD, in the future collection accounts could be opened in the name of the fund, the manager on behalf of the fund or the depositary. In this way, collection accounts may not fall under CAR.

Other jurisdictions, for example Luxembourg, where client asset rules have traditionally applied to fund providers, have wrestled with these issues for some time. This has led to a number of approaches primarily focusing on control of the account and reliance on appropriate powers of attorney. Equally, other fund providers have sought to rely on clear disclosure to customers that the accounts in question would not be treated as client asset accounts.

While such proposals merit further consideration, it is clear that the Central Bank, through CP71, is looking to bring clarity to the treatment of collection accounts under the CAR. Some firms will look to adopt structures and legal interpretations to exclude themselves from the CAR, potentially setting the scene for a regulatory showdown. The legal ramifications of such structuring are untested and may not be fully clear in a potential insolvency situation. Also firms need to consider how their existing obligations under other legislation, for example AML requirements, will be impacted by the CAR and any attempt to restructure the collection account as a fund asset.

How can we help?

We can assist firms in meeting their obligations under the CAR in any of the following ways:

- Impact and gap analysis
- Target model design and implementation
- Risk mitigation
- CAMP production / review
- CAR training, CAOR training, board training
- CAKID development
- Development of processes and procedures

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