



Link'n Learn  
Client Asset rules  
across Europe



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# Presenters

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# Link'n Learn

## Agenda

1. Introduction and context
2. Client Assets in the UK
3. Client Assets in Ireland
4. MiFID II and Client Assets
5. Questions and Answers

# 1. Introduction and context

## 2. Client Assets in the UK

# FRC Client Assets Standard

## Introduction and background

- A new Assurance Standard applicable to CASS Auditors
- The Client Assets Standard will replace FRC's Bulletin 2011/2 and Bulletin 3
- Client Assets Standard effective for periods commencing on or after 1 January 2016
- Bulletins provide auditors with guidance that are “persuasive” and Standard is “prescriptive”
- Work by the auditors is now a requirement rather than guidance
- Scope of the proposed Client Assets Standard has not changed, i.e. still limited to compliance with the rules in CASS 3, 6, 7 and 8 (where applicable) for “during the period” and “as at the period end”
- The CASS auditor is to adopt an insolvency mind-set, which places greater emphasis on evaluating that processes and controls are deemed adequate in the face of insolvency
- Firms are strongly encouraged to look at the new requirements in the FRC Standard in readiness for CASS auditor's review from 2016 / 2017 onwards

# FRC Client Assets Standard

## Impact to the CASS audit - General

- Requires the CASS auditor to have a more holistic review of the firm's CASS Risk and Control Framework covering the three line of defence
- A CASS assurance engagement should only be accepted (or continued) when the CASS auditor meet the relevant ethical requirements including independence – unlikely to be able to split statutory auditor and CASS auditor supplier
- CASS auditor need to consider the control environment and evaluate whether management and those charged with Governance seek to maintain a culture of honesty and ethical behaviour towards the beneficial owners of the client assets
- A specific requirement to communicate with management and those charged with Governance, deficiencies in internal control that could impact the adherence to the CASS rules. This will be done via a Management Letter
- Separate CASS engagement letters (“EL”) from the statutory engagement letters
- Where the firm outsources functions to a Third Party Administrator (“TPA”) the CASS EL should explicitly set out the rights of access to the TPA
- The CASS auditor is to understand, assess and document whether Internal Audit and/or Compliance have performed activities in relation to Client Assets in the period [please see further slide on IA and Compliance]

# FRC Client Assets Standard

## Requirements of the firm

- Formalisation of documentation around controls and risks. The risk assessment should identify all in-scope CASS rules to the risks faced of breaching each CASS rule. For each risk identified, the controls in place to mitigate those risks will then need to be identified and documented.
- A CASS rule mapping indicating all CASS rules that are both in and out of scope clearly mapped to each legal entity and business area subject to CASS
- The firm will need to have a documented inventory of CASS systems, processes and controls. From this controls matrix, the auditor should be able to identify which controls sit over which process, and make an assessment of whether the preventative and detective controls are designed in such a way that would ensure on-going compliance with the relevant CASS rule set
- Detailed process maps for asset and cash-flows that clearly identify where and how client money and assets are held and registered at each stage of the client assets lifecycle.
- Documentation of each group member or third party that performs a CASS function, the contractual arrangements in place and how the firm exercises oversight of these arrangements.
- Lack of the above could result in increased work by the CASS auditor to produce the assessments (with an impact on fees) or indeed a potential qualification or disclaimer if an opinion cannot be reached due to the lack of evidence

# FRC Client Assets Standard

## Requirements of Internal Audit and Compliance

- The Standard more formally puts an obligation on the external assurance provider to assess the way in which Internal Audit addresses CASS.
- Internal audit should perform its own independent risk assessment in relation to CASS. Unlike the assessment required by management, it will not necessarily be a rule-by-rule assessment, but would expect it to be comprehensive and be able to demonstrate it has followed a systematic process.
- The assessment is likely to leverage the firm's CASS risk framework, but it must still provide independent challenge to the risk assessment performed by the firm.
- It is expected that IA would consider the implications if its own CASS risk assessment differed from that performed by the first line.
- Internal audit should create a testing strategy that covers all CASS risk areas on a rolling basis (every 3 years being the maximum acceptable review period for lower risk areas). The areas of higher risk identified in the IA CASS risk assessment should be assessed with a greater frequency and depth (at least annually).
- Thematic reviews are an acceptable approach as long as there is good coverage over the key risk areas and they are supported by comprehensive first and second line rule by rule monitoring activities. This is more achievable if the first line and second line monitoring and control functions are both sufficiently robust and distinct from one another and the first line takes appropriate ownership of and maintains the overall control framework; enabling compliance to perform a genuine programme of monitoring, testing and challenge.
- Findings and recommendations from IA should feed back into the firm's overall CASS risk assessment.
- One of the key focus areas for the external assurance provider and one of the areas on which we will focus when assessing the internal monitoring is how assurance over the completeness and accuracy of information used for monitoring is ensured.

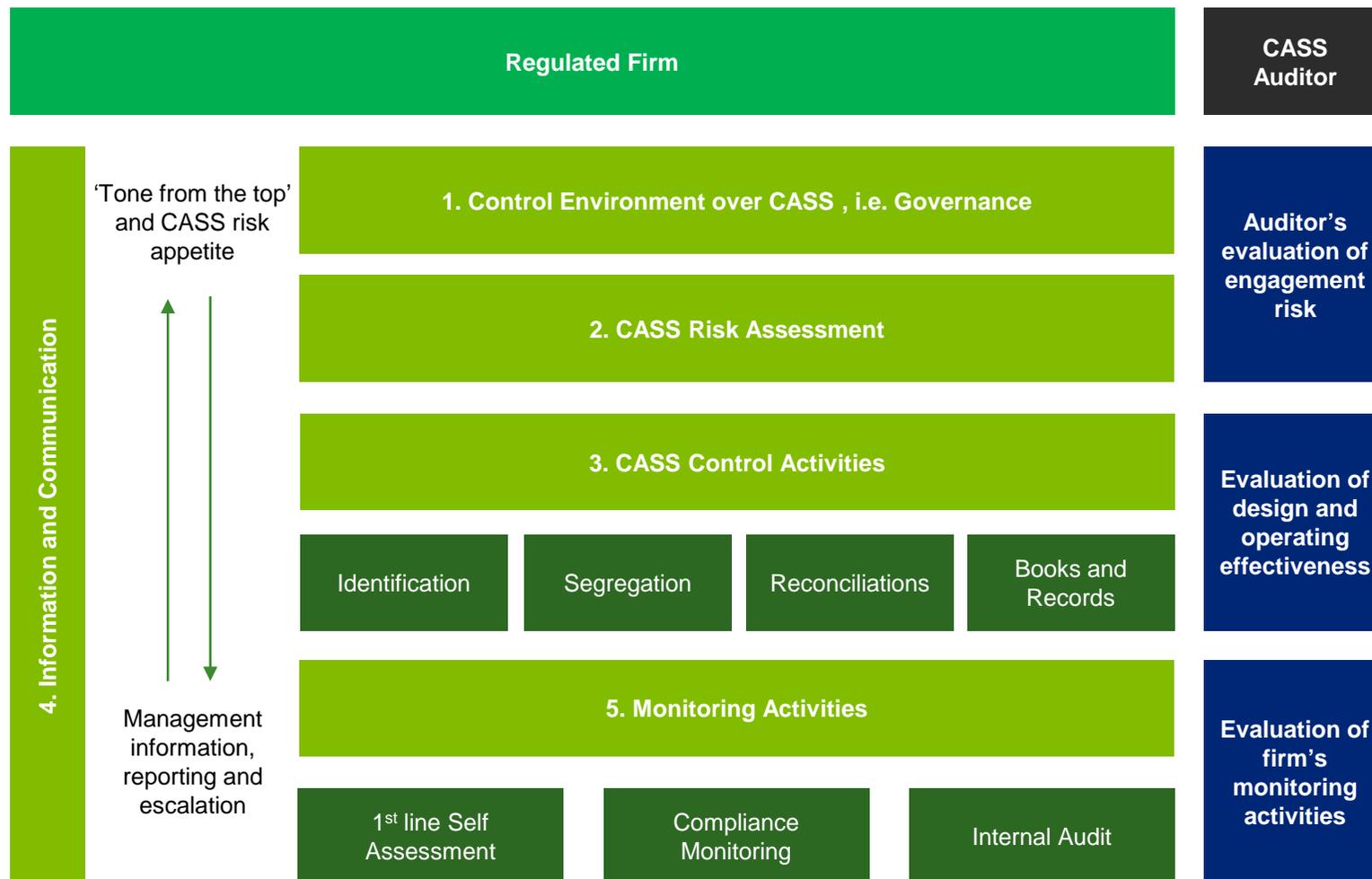
### What will the CASS auditor do?

- Review the risk assessment performed by IA, and assess the sufficiency of scope and frequency of its CASS monitoring.
- Consider how IA aligns to the first and second lines to promote a strong and integrated control framework for the firm overall.
- Assess how control findings identified by IA have been addressed by the firm, have impacted the firm's CASS risk assessment; and how they have been followed up by IA.
- Assess the sources of information used in monitoring activities and the basis upon which IA considers the information to be sufficiently reliable for the purpose.

# FRC Client Assets Standard

## CASS Control framework at the firm

The Standard assumes that firms have a CASS Control Framework that the CASS Auditor can assess.



# 3. Client Assets in Ireland

# IMR Emerging Operating Models

## Investor Money / Fund Assets

An industry working group has been liaising with the Central Bank of Ireland to set out the potential operating models that might be used within FSP's to allow them to achieve compliance with the Regulations and/or apply the alternative Fund Asset model with some efficiency, depending on the structure of their business. Whilst some details may require further clarity, it seems that there are three standard options available to firms.

### Fund Assets Only

The collection account is an asset of the fund, and the Investor Money Regulations do not apply.

- The cash account of the fund is effectively its operating account for all cash activity.
- The bank account is in the name of the Fund, or the Manager on behalf of the Fund, or the Depository on behalf of the Fund and subject to applicable fund rules.
- May be more suited to a fund that settles contractually, and where the likelihood of an investor paying before dealing day or of investor money remaining 'unclaimed' is low.
- Fund and Depository support is necessary to operate this model.

### IMR Account Only

All incoming subscription proceeds and all outgoing investor payments flow through an Investor Money account.

- Until the cash currency cut-off on dealing day, the FSP holds all subscription monies on behalf of investors who have applied to subscribe into the fund.
- From the date investor money leaves a fund (e.g. in the case of a redemption or dividend), the FSP holds it until it can be paid to the investor.
- May be more suited to a fund that settles on a 'cleared funds' basis for subscriptions.
- Once the money in the Collection Account becomes an asset of the Fund (i.e.. on dealing day), it is moved to the cash account of the fund (with the depository or prime broker).
- Any money received after dealing day must be moved to the Fund without delay once it is identified.

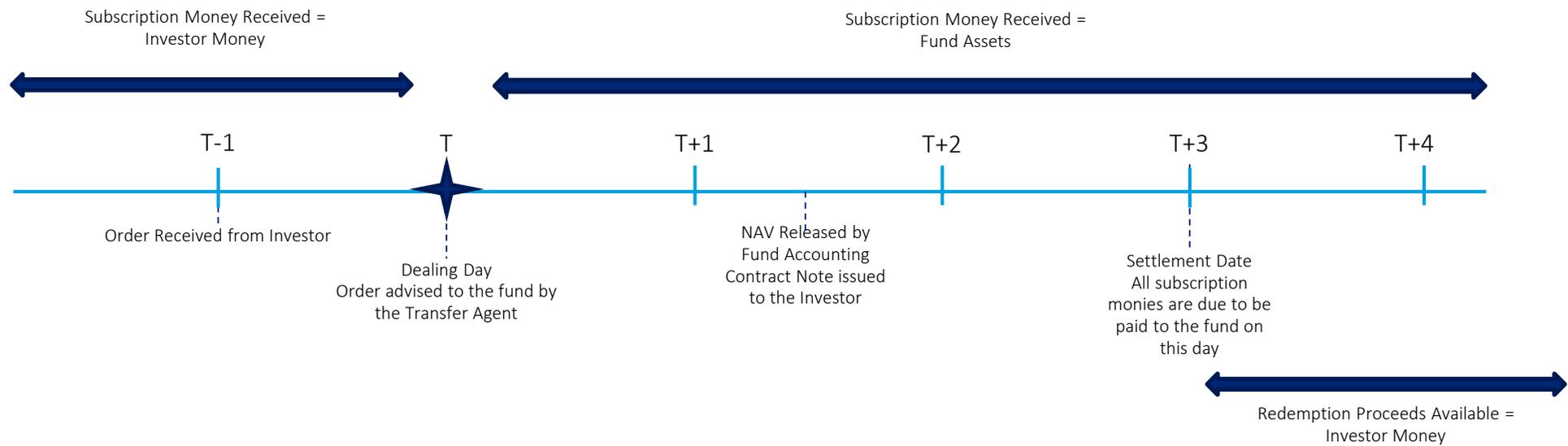
### Hybrid

Subscription and redemption proceeds flow through a Fund Asset account. Exceptions are lodged into an Investor Money Account.

- The FSP maintains an Investor Money Account, into which investor money is lodged if it is 'unclaimed' by the investor, or if it can not be paid because there is CDD or other information outstanding for the investor.
- May be more suited to a fund that settles contractually.
- The Fund Asset account is subject to Depository oversight.
- Requires Fund and Depository support to operate this model.
- The details of when investor money is lodged into the FSP's Investor Money account should be documented in the FSP's Investor Money Management Plan ('IMMP') and the Fund's Cash Management Policy (in particular where operating an Umbrella level cash account)

# IMR / Fund Assets

## Investor Money v's Fund Money



# IMR / Fund Assets

## Operational Challenges

### IMR

- ❖ Treatment of accounts held in recognised clearing systems
- ❖ Management of the ledger / cash position of the FSP and daily reconciliation requirements
- ❖ Lack of clarity on CBI reporting requirements
- ❖ Autonomy in setting materiality thresholds

### Fund Assets

- ❖ Evolving 'rules' for umbrella level fund cash accounts
- ❖ Treatment of non-investor related payments (e.g. rebates)

# 4. MiFID II and Client Assets

# MiFID II – Impact on Client Assets Protection

## Introduction and background

- MiFID II has significantly increased requirements for safeguard of client assets
- The main areas where MiFID II has increased requirements include:
  - Safeguarding client assets
  - Depositing client financial instruments/client funds
  - Use of client financial instruments
  - Title Transfer Collateral Arrangements
  - Governance

### Timeline:

- Level 1 text for MiFID II which contained a high level requirement with respect to safeguard of client assets was issued in May 2014
- Delegated directive (level 2 text) supplementing MiFID II level 1 text, with regard to safeguard of client assets, was issued in April 2016
- Both Level 1 and Level 2 texts will be applicable from January 2018

# MiFID II – Impact on Client Assets Protection

## Safeguarding client assets

- The client assets shall not be subject to any security interest, right to set off or lien for the benefit of a third party. The only exception is; if such security interest, right to set off or lien is granted by local law of the country where client assets are deposited. In such case, the investment firms shall disclose these risks to clients. This should be recorded in client agreements as well as in the firm's internal records.
- Member states to prescribe 'other equivalent measures' where a firm deposits client assets/money in a third country and, due to the local law, it is not able to comply with the requirements of segregation of such assets.
- However, if relying on 'other equivalent measures' the firm shall disclose to clients that it will be relying on 'other equivalent measures' and clients will not benefit from protection afforded by MiFID II in such instances.
- Investment firms will be required to provide information pertaining to client assets/money to regulators, insolvency practitioners and any other individual responsible for failed firms.

### Key Impact

- Protection for client assets against 3<sup>rd</sup> party security interest, right to setoff and lien
- Mandatory disclosure to clients where due to local law in a 3<sup>rd</sup> country, the firm will not be able to comply with the segregation requirements for client assets
- Requirement to keep client assets insolvency resolution pack

# MiFID II – Impact on Client Assets Protection

## Depositing client financial instrument/client funds:

- In case, sub-custodian deposits client assets with another third party sub-custodian, investment firms will be required to perform due diligence on such third party sub-custodian to ensure it has adequate controls to safeguard client assets
- Consent will be required from clients before investment firm can deposit client money into a qualifying money market fund (QMMF). And firms should inform clients that such placement will not be covered under the 'safeguarding of client funds' article in MiFID.
- As part of MiFID II, the firms will be required to consider the diversification of funds with respect to client money that they have deposited with different banks. As part of such considerations, the firm cannot deposit more than 20% of client funds with a credit institute, bank or QMMF which is a member of the firm's group. However, the compliance with 20% rule is not required where a firm can demonstrate that the balance held with such group entity
  - is minimal, due to the nature, scale and complexity of the its business; and the safety offered by third party

Therefore, it is appropriate to deposit money with such group entity. However, such assessment must be reviewed periodically and shall be submitted to regulators.

### Key Impact

- Increased requirement to perform due diligence
- In this section MiFID II delegated act has removed definition of qualified money market fund from original MiFID Implementing directive text.
- Introduction of diversification requirements for client money deposits

# MiFID II – Impact on Client Assets Protection

## Use of clients financial instruments:

- Written prior consent is required before firms can enter into securities financing arrangements
- The firms will be required to prevent un authorised use of clients' assets for their own account or account of another. To this end they will be expected to
  - Include in client agreement measures to prevent such unauthorised use.
  - Monitoring of firm's ability to deliver on the settlement date and putting in place of remedial measures if this cannot be done.
  - Monitoring of unsettled trades
- The firms will also be required to have borrower of financial instruments deliver appropriate securities (e.g. in sec lending arrangement) and monitors the appropriateness of such collateral against the value of client assets lent

### Key Impact

- The protection against unauthorised use of client assets would require the require firm's to follow a shortfall process. This would create an additional compliance risk and operational burden on the firm.
- Greater protection to client for security financing transactions

# MiFID II – Impact on Client Assets Protection

## Title Transfer Collateral Arrangements and Governance

### TTCA

- Investment firms cannot enter into TTCA arrangements for retail clients.
- In case of TTCA with professional clients, the firm will be required to demonstrate that it has considered the use of TTCA for its client. The MiFID II delegated act has adopted ESMA's technical advice in this regard and included minimum considerations that firms need to consider before entering into a TTCA for a professional client.

### Governance

- A separate individual to be responsible for
  - the governance of client assets environment; and
  - compliance by the firm of rules to safeguard client assets/money.

### Key Impact

- Defined minimum criteria that firms need to consider before entering into a TTCA for retail clients
- Appointment of a dedicated individual to ensure client assets governance

# 5. Questions and Answers



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