

**CONSULTATION PAPER**

**(CP- 2020-01)**



**SUBJECT:** **CONSULTATION PAPER ON ENHANCEMENT OF PROCEDURES REGARDING SAFEGUARDING OF CLIENT FUNDS HELD BY CIFs**

**DATE OF ISSUE: 4 MAY 2020**

## PURPOSE OF THIS CONSULTATION PAPER

This Consultation Paper (the “Consultation”) helps enact effective consultation procedures between the Cyprus Securities and Exchange Commission’s (“CySEC”) and market participants regarding the proposed enhancement of procedures for safeguarding of client funds held by CIFs.

## IMPORTANT WARNING

The submission of responses should be made **no later than 18 May 2020**. No extension will be given on an individual basis. Therefore, unless CySEC extends the submission period with a formal announcement, any responses received after the above date **will not be considered**.

## INSTRUCTIONS FOR THE SUBMISSION OF RESPONSES

Interested parties may submit their responses to CySEC’s Supervision Department by email at [crdsubmission@cysec.gov.cy](mailto:crdsubmission@cysec.gov.cy).

The subject of the email should have the following form:

«*Consultation Paper (2020 - 01) – [insert the Name of Organisation, Legal or Natural Person submitting the comments or views]*»

In submitting your responses, you are requested to state whether you represent an organized group or a specific enterprise, or if you are an individual. In the case of organized groups, you are kindly requested to provide information on the number and nature of persons or enterprises you represent.

Please answer the questions in the order presented in this document be concise and provide your replies in a Word document.

**CONTENT****CONSULTATION PAPER ON ENHANCEMENT OF PROCEDURES REGARDING  
SAFEGUARDING OF CLIENT FUNDS HELD BY CIFs**

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## 1. INTRODUCTION

- 1.1. The Cyprus Securities and Exchange Commission (“CySEC”) publishes this Consultation Paper to propose the enhancement of procedures regarding the safeguarding of client funds held by CIFs. CySEC intends to publish a Circular that will further enhance the procedures that CIFs are following for the safeguarding of their client funds (**the “Proposed Circular”**).

## 2. REGULATORY FRAMEWORK

- 2.1. Section 17 (9) of the Investment Services and Activities and Regulated Markets Law of 2017 Law ('the Law') states “*A CIF must, when holding funds belonging to clients, make adequate arrangements to safeguard the rights of clients and, except in the case of credit institutions, to prevent the use of client funds for its own account*”.
- 2.2. Section 17 (10) of the Law states “*A CIF shall not conclude title transfer financial collateral arrangements with retail clients for the purpose of securing or covering present or future, actual or contingent or prospective obligations of clients*”.
- 2.3. Part II of the CySEC’s Directive DI87-01 (the ‘Directive’) further specifies the requirements for the safeguarding of clients assets.

## 3. SCOPE

- 3.1. The **Proposed Circular** is addressed to all CIFs that are permitted to hold client funds for the provision of investment services as defined in Part 1, Appendix A of the Law.

## 4. SUMMARY OF THE PROPOSED CIRCULAR

### 4.1. Requirement for holding separate clients’ accounts

- 4.1.1. The title of the clients’ bank account should sufficiently distinguishes that account from any account used to hold funds belonging to the CIF, as it is required by paragraph 4(1)(e) of the Directive (i.e. denoted as clients’ accounts).
- 4.1.2. In some cases, the applicable law of the jurisdiction in which the clients’ funds are held, prevent CIFs from complying with the requirement of paragraph 4(1)(e) of the Directive.
- 4.1.3. CySEC has described further requirements that should apply in the abovementioned cases, as stated in point 6 of the **Proposed Circular**.

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**Question 1:** Do you agree with the requirements, as stated in point 6 of the **Proposed Circular**, that CIFs should follow in case the applicable law of the jurisdiction in which the client funds are held, prevent them from complying with the requirement of paragraph 4(1)(e) of the Directive?

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If you disagree, please state your suggestions for alternative measures that may be implemented.

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#### **4.2. Use of Payment Service Providers (PSPs) and Electronic Funds Institutions (EMIs)**

4.2.1. CIFs may maintain merchant accounts with PSPs and EMIs for the clearing/settlement of their clients' payment transactions (inwards and outwards payments).

4.2.2. CIFs must, at all times, ensure that:

- i. clients' funds are transferred to clients' accounts held by the CIF with an entity, per paragraph 6(1) of the Directive, immediately after the clearing/settlement of the payment transactions with a PSP/an EMI,
- ii. the funds equal to rolling reserves or fix deposits with PSPs/EMIs are transferred from the CIF's own funds in the clients' account held by the CIF with an entity, per paragraph 6(1) of the Directive,
- iii. they only allow clients to trade with immediate effect, before the clearing of their funds, only in cases where the CIF is licensed to provide the ancillary service of paragraph 2, Part II of the Law (granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction) and the CIF transfers the corresponding amount before trading from its own funds to a client account with an entity of par. 6(1) of the Directive.

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**Question 2:** Do you have any comments on the above issues as detailed in points 7 to 11 of the **Proposed Circular**?

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#### **4.3. Due diligence and diversification of institutions holding clients' funds**

4.3.1 Par. 6(2) of the Directive states that, where a CIF does not deposit client funds with a central bank, the CIF shall exercise all due skill, care and diligence in the selection, appointment and periodic review of the credit institutions and banks authorised in a third country (hereafter banks), where the funds are placed and the arrangements for the holding of those funds and take into consideration the need for diversification of these funds as part of the required due diligence.

4.3.2. CySEC expects that CIFs:

- i. on a regular basis (and no less than once in each financial year) will perform due diligence procedures of the banks where clients' funds are placed,
  - ii. will diversify placements of client funds with more than one bank where the amounts are, for example, of sufficient size to warrant such diversification,
  - iii. when selecting a bank where client funds are placed they will take into consideration the factors mentioned in point 15 of the **Proposed Circular**.
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**Question 3:** Do you agree that a CIF should take into consideration the factors detailed in point 15 of the **Proposed Circular** when selecting a bank to place clients' funds?

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#### **4.4. Depositing clients' funds with a bank or qualifying money market fund of the same group as the CIF**

4.4.1. Par. 6(3) of the Directive states that, where a CIF deposits client funds with a bank or money market fund of the same group as the CIF, then the CIF must limit the funds that are deposited with any such group entity or combination of any such group entities so that the funds do not exceed 20% of all such funds.

4.4.2. The CIF may not comply with this limit where it is able to demonstrate that, in view of the nature, scale and complexity of its business, and also the safety offered by the third parties referred to in above, and including in any case the small balance of client funds that the CIF holds, the requirement under paragraph 6(3) of the Directive is not proportionate. The CIF periodically reviews the assessment made in accordance with this subparagraph and notifies its initial and revised assessments to CySEC.

4.4.3. CySEC considers that a CIF in the context of complying with its obligation to periodically review its initial assessment it should undertake:

- i. a review and, where appropriate, should consider ceasing to use this exception when a change in the circumstances arises that might have led the CIF to a different conclusion on its previous assessment;
- ii. a review at least when a year has elapsed since its previous assessment.

4.4.4. CySEC considers that the amount of small balance of clients' funds with a bank or money market fund of the same group as the CIF should be, at any point of time, the lower of the:

- i. €3.000.000 and
- ii. 50% of the total clients' funds held by the CIF.

#### **4.4.5. Example A**

As at 31 December 20XX the CIF ‘A Ltd’ holds total clients’ funds of €15.000.000. Client funds of €5.000.000 are held with its parent entity, ‘Bank B’. The remaining client funds of €10.000.000 are held with other unrelated banks.

According to CySEC’s small balance guidance of point 4.4.4 above the small balance that A Ltd may maintain at all times with its parent entity ‘Bank B’ is €3.000.000 (=the lower of (a) €3.000.000 and (b) €7.500.000 (=50%\*15.000.000)).

Thus, CIF ‘A Ltd’ should take appropriate measures to reduce the client funds held with its parent entity ‘Bank B’ to €3.000.000 at all times.

#### **4.4.6. Example B**

As at 31 December 20XX the CIF ‘Z Ltd’ holds total clients’ funds of €2.000.000. Client funds of €1.500.000 are held with its related entity ‘Bank W’ and the remaining €500.000 are held with another unrelated bank.

According to CySEC’s small balance guidance of point 4.4.4 above the small balance that Z Ltd may maintain at all times with its related ‘Bank W’ is €1.000.000 (=the lower of (a) €3.000.000 and (b) 1.000.000 (=50%\*2.000.000)).

Thus, CIF ‘Z Ltd’ should take appropriate measures to reduce the client funds held with its related entity ‘Bank W’ to €1.000.000 at all times.

**Question 5:** Do you have any comments on the steps to be taken by a CIF regarding its obligation to periodically review its initial assessment of related banks that clients’ funds are placed?

**Question 6:** Do you agree with the CySEC’s guidance for the small balance of client funds that a CIF should maintain at all times with related banks as stated above and in point 19 of the Proposed Circular?

#### **4.5. Use of Title Transfer Collateral Arrangements (“TTCAs”)**

CIFs are not entitled to:

- i. transfer funds belonging to retail clients to a third party, as there is an outright prohibition of such practice in section 17(10) of the Law,
- ii. arbitrarily transferring funds belonging to non-retail clients, without taking into account the factors provided for in par. 8(1) of the Directive, without being able to demonstrate that a TTCA would be appropriate for that non-retail client and without properly informing the non-retail client for the risks entailed, as per Paragraph 8(3) of the Directive.

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**Question 7:** Do you have any comments on the points raised above for the use of TTCAs?

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#### **4.6. Maintaining a ‘buffer’ in clients’ bank accounts**

4.6.1. CIFs may decide to place an amount of their own funds into clients’ bank accounts (i.e. maintain a ‘buffer’) in order to:

- i. facilitate the smooth running of their business,
- ii. ensure no delays,
- iii. cover clients’ funds with PSP/EMI,
- iv. manage the foreign exchange risk from maintaining clients’ funds in a different currencies,
- v. to cover possible shortfalls.

4.6.2. It is up to the CIF to decide the amount of the ‘buffer’ that will be maintained. CySEC emphasizes that these funds are considered as clients’ funds and are subject to the regulatory requirements of the Directive and the Law.

4.6.3. CySEC expects CIFs to establish a written policy that is approved by their board of directors, which will include the specific risks and amount that the CIF intends to cover and retain from its own funds into clients’ accounts with an entity of par. 4(1) of the Directive, justifying the amount of the their own funds kept in their clients’ bank accounts (i.e. ‘buffer’).

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**Question 8:** Do you have any comments on the procedures set by CySEC regarding the amount of CIF’s own money that may be kept with clients’ bank accounts (i.e. ‘buffer’)?

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#### **4.7. Single officer for the safeguarding of client financial instruments and funds**

4.7.1. Par. 9 of the Directive states that a CIF should appoint a single officer of sufficient skill and authority with specific responsibility for matters relating to the CIF’s compliance with its obligations regarding the safeguarding of client financial instruments and funds. A single officer will have overall responsibility for the safeguarding of client instruments and funds should be appointed in order to reduce risks of fragmented responsibility across diverse departments, especially in large and complex CIFs, and to remedy unsatisfactory situations where CIFs do not have overarching sight of their means of meeting their obligations.

#### 4.7.2. The single officer:

- i. should possess sufficient skills and authority in order to discharge duties effectively and without impediment, including the duty to report to the CIF's senior management in respect of oversight of the effectiveness of the CIF's compliance with the safeguarding of client assets requirements.
  - ii. is expected to verify the accuracy and completeness of clients' money reconciliation that will be included in CySEC's QST-CIF Form (ie. Reconciliation of Sections B and C of the said Form).
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**Question 9:** Do you have any comments on CySEC's expectations regarding the single officer for the safeguarding of client financial instruments and funds?

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#### 4.8. Reconciliation of clients' funds

4.8.1. Par. 4(1)(c) of the Directive state that «*The CIF must conduct on a regular basis reconciliations between its internal accounts and records and those of any third parties by whom those assets are held*».

4.8.2. When a CIF undertakes transactions for its clients on a daily basis, CySEC expects that reconciliations of clients' funds will be contacted on each business day on the records of the CIF as at the close of business of the previous business day.

4.8.3. CIFs must ensure that reconciliations are performed between:

- i. Clients' bank accounts or any other third party holding clients' funds (as per CIF records) Vs bank statements or any other third party statements.
- ii. Client bank accounts or any other third party holding clients' funds (as per CIF records) Vs clients' equity (as per CIF records).

Equity includes deposits/withdrawals, credits, realised and unrealised profits/losses and represents the actual funds owed to each client.

4.8.4. The internal auditor and the compliance officer of the CIF are expected to verify the accuracy and completeness of the clients' money reconciliation performed by the CIF and report to Board of the Directors of the CIF accordingly.

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**Question 10:** Do you have any comments on the procedures suggested by CySEC regarding clients' funds reconciliation?

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#### 4.9. Other matters

4.9.1. CySEC sets guidance regarding the signatories of clients' accounts with entities of par. 4(1) of the Directive are concerned and the use of clients' accounts as stated in points 33 and 35 of the **Proposed Circular**.

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**Question 11:** Do you have any comments on the guidance suggested by CySEC in points 33 and 35 of the **Proposed Circular**?

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#### 5. MISCELLANEOUS

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**Question 12:** Do you have any other comments on the issues raised in the **Proposed Circular**?

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**APPENDIX 1 - PROPOSED CIRCULAR****A. Regulatory framework**

1. According to section 17 (9) of the Investment Services and Activities and Regulated Markets Law of 2017 Law ('the Law') "*A CIF must, when holding funds belonging to clients, make adequate arrangements to safeguard the rights of clients and, except in the case of credit institutions, to prevent the use of client funds for its own account*".
2. According to section 17 (10) of the Law "*A CIF shall not conclude title transfer financial collateral arrangements with retail clients for the purpose of securing or covering present or future, actual or contingent or prospective obligations of clients*".
3. The requirements for the safeguarding of clients assets are further specified in Part II of CySEC's Directive DI87-01 (the 'Directive').

**B. Requirement for holding separate clients' accounts**

4. According to paragraph 6(1) of the Directive, CIFs must, upon receiving any client funds, promptly place those funds into one or more accounts opened with any of the following entities:
  - a. central bank
  - b. credit institution as defined in article 2(1) of the Business of Credit Institutions Law
  - c. bank authorised in a third country
  - d. qualifying money market fund
5. It is provided that the title of the clients' account sufficiently distinguishes that account from any account used to hold funds belonging to the CIF, as it is required by paragraph 4(1)(e) of the Directive (i.e. denoted as clients' accounts).
6. Having exercise the powers provided for in paragraph 4(2) of the Directive, CySEC prescribes below the requirements that CIFs must apply in case the applicable law of the jurisdiction in which the clients' funds are held, prevent them from complying with the requirement of paragraph 4(1)(e) of the Directive (clients' accounts identified separately from any accounts used to hold funds belonging to the CIF):
  - a. CIFs must notify the entity of par. 6(1) of the Directive, with whom the clients' account is opened, that they are obliged to keep clients' funds separate from their own funds. This communication should be kept in the CIFs' records and be available for review by CySEC.
  - b. CIFs must demonstrate to CySEC that they had no other alternative but to conduct such business, given the risk to clients' funds in the event of the entity's insolvency.
  - c. CIFs must demonstrate to CySEC that they have done everything in their powers to obtain separately titled accounts, including using another third party.

If a CIF cannot demonstrate to CySEC that it has fully applied the abovementioned requirements, then CySEC may request from the CIF to segregate an equivalent amount of its own funds in a separately titled account in another jurisdiction where the CIF can comply with the requirement of paragraph 4(1)(e) of Directive.

#### **C. Use of Payment Service Providers (PSPs) and Electronic Funds Institutions (EMIs)**

7. CIFs may maintain merchant accounts with PSPs and EMIs for, among other purposes, the clearing/settlement of their clients' payment transactions (inwards and outwards payments).
8. CIFs must, at all times, ensure that clients' funds are transferred to clients' accounts held by the CIF with an entity, as defined in par. 4 above, immediately after the clearing/settlement of the payment transactions.
9. Where it is the CIF's policy, upon accepting a deposit through electronic means and before the clearing of the funds, to credit its client trading account with the corresponding amount in order for the client to trade with immediate effect, the CIF must ensure that the corresponding amount is transferred before trading, unless part G below applies, from its own funds to client account held by the CIF with an entity, as defined in par. 4 above. These funds are considered as clients' funds and are subject to the corresponding regulatory requirements.
10. A CIF can act as described in par. 9 above only if it is licensed to provide the ancillary service of paragraph 2, Part II of the Law (granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction).
11. Where the PSP and EMI withhold funds, as rolling reserve or fix deposit, for chargeback or other purposes, for a period of time before releasing the funds to the CIF, the CIF must ensure that the funds equal to rolling reserves or fix deposits, are transferred from the CIF's own funds in the clients account held by the CIF with an entity, as defined in par. 4 above, to ensure compliance with the provisions of paragraph 6(1) of Directive.

#### **D. Due diligence and diversification of institutions holding clients' funds**

12. According to par. 6(2) of the Directive, where a CIF does not deposit client funds with a central bank, the CIF shall exercise all due skill, care and diligence in the selection, appointment and periodic review of the credit institutions and banks authorised in a third country (hereafter banks), where the funds are placed and the arrangements for the holding of those funds and take into consideration the need for diversification of these funds as part of the required due diligence.
13. CIFs are expected on a regular basis (and no less than once in each financial year) to perform due diligence procedures of the banks where clients' funds are placed.

- 14.** CIFs should consider diversifying placements of client funds with more than one bank where the amounts are, for example, of sufficient size to warrant such diversification.
- 15.** CySEC expects CIFs to consider the following when selecting a bank where clients' funds are placed:
  - a. the capital of the bank;
  - b. the amount of client funds placed, as a proportion of the bank's capital and deposits;
  - c. the credit rating of the bank(if available); and
  - d. to the extent that the information is available, the level of risk in the investment and loan activities undertaken by the bank and its affiliated companies.

**E. Depositing clients' funds with a bank or qualifying money market fund of the same group as the CIF**

- 16.** According to paragraph 6(3) of the Directive, where a CIF deposits client funds with a bank or money market fund of the same group as the CIF, then the CIF must limit the funds that are deposited with any such group entity or combination of any such group entities so that the funds do not exceed 20% of all such funds.
- 17.** The CIF may not comply with this limit where it is able to demonstrate that, in view of the nature, scale and complexity of its business, and also the safety offered by the third parties referred to in above, and including in any case the small balance of client funds that the CIF holds, the requirement under the paragraph 6(3) of the Directive is not proportionate. The CIF periodically reviews the assessment made in accordance with this subparagraph and notifies its initial and revised assessments to CySEC.
- 18.** CySEC considers that a CIF in the context of complying with its obligation to periodically review its initial assessment it should undertake:
  - a. a review and, where appropriate, should consider ceasing to use this exception when a change in the circumstances arises that might have led the CIF to a different conclusion on its previous assessment;
  - b. a review at least when a year has elapsed since its previous assessment.
- 19.** CySEC considers that the amount of small balance of clients' funds with a bank or money market fund of the same group as the CIF should be, at any point of time, the lower of the:
  - a. €3.000.000
  - b. 50% of the total clients' funds held by the CIF.

**F. Use of Title Transfer Collateral Arrangements ("TTCAs")**

- 20.** CIFs are not entitled to:
  - a. transfer funds belonging to retail clients to a third party, as there is an outright prohibition of such practice in section 17(10) of the Law.

- b. arbitrarily transferring funds belonging to non-retail clients, without taking into account the factors provided for in par. 8(1) of the Directive, without being able to demonstrate that a TTCA would be appropriate for that non-retail client and without properly informing the non-retail client for the risks entailed, as per Paragraph 8(3) of the Directive.

#### **G. Maintaining a ‘buffer’ in clients’ bank accounts**

- 21.** CIFs may decide to maintain a ‘buffer’ of own funds into clients’ bank accounts in order to:
  - a. facilitate the smooth running of their business,
  - b. ensure no delays,
  - c. cover clients’ funds with PSP/EMI,
  - d. manage the foreign exchange risk from maintaining clients’ funds in a different currencies,
  - e. to cover possible shortfalls.
- 22.** It is up to the CIF to decide the amount of the ‘buffer’ that will be maintained. CySEC emphasizes that these funds are considered as clients’ funds and are subject to the regulatory requirements of the Directive and the Law.
- 23.** For this purpose, CIFs must establish a written policy that is approved by their board of directors, which includes the specific risks and amount that the CIF intends to cover and retain from its own funds into clients’ accounts with an entity of par. 4(1) of the Directive, justifying the amount of the ‘buffer’ kept.

#### **H. Single officer for the safeguarding of client financial instruments and funds**

- 24.** According to par. 9 of the Directive a CIF should appoint a single officer of sufficient skill and authority with specific responsibility for matters relating to the CIF’s compliance with its obligations regarding the safeguarding of client financial instruments and funds. A single officer with overall responsibility for the safeguarding of client instruments and funds should be appointed in order to reduce risks of fragmented responsibility across diverse departments, especially in large and complex CIFs, and to remedy unsatisfactory situations where CIFs do not have overarching sight of their means of meeting their obligations.
- 25.** The single officer should possess sufficient skills and authority in order to discharge duties effectively and without impediment, including the duty to report to the CIF’s senior management in respect of oversight of the effectiveness of the CIF’s compliance with the safeguarding of client assets requirements.
- 26.** The single officer is expected to verify the accuracy and completeness of the clients’ money reconciliation that will be included in CySEC’s QST-CIF Form (ie. Reconciliation of Sections B and C of the said Form).

- 27.** CIFs are expected to complete and keep up to date the details of their single officer for the safeguarding of client financial instruments and funds in CySEC's portal.

**I. Reconciliation of clients' funds**

- 28.** According to paragraph 4(1)(c) of the Directive «*The CIF must conduct on a regular basis reconciliations between its internal accounts and records and those of any third parties by whom those assets are held*».

- 29.** In determining the term 'regular basis', CIFs should consider the risks which their business is exposed, such as the nature, volume and complexity of the business, and where and with whom the clients' funds are held.

- 30.** When a CIF undertakes transactions for its clients on a daily basis, CySEC expects that reconciliations of clients' funds will be contacted on each business day on the records of the CIF as at the close of business of the previous business day.

- 31.** CIFs must ensure that reconciliations are performed between:

- a. Clients' bank accounts or any other third party holding clients' funds (as per CIF records) Vs bank statements or any other third party statements.
- b. Client bank accounts or any other third party holding clients' funds (as per CIF records) Vs clients' equity (as per CIF records).

Equity includes deposits/withdrawals, credits, realised and unrealised profits/losses and represents the actual funds owed to each client.

It is expected that reconciling items should only arise due to timing differences and cleared within a few days.

- 32.** The internal auditor and the compliance officer of the CIF are expected to verify the accuracy and completeness of the clients' money reconciliation performed by the CIF and report to Board of the Directors of the CIF accordingly.

**J. Other matters**

- 33.** As far as clients' accounts with entities of par. 4(1) of the Directive are concerned, CIFs must ensure that there are at least two persons with combined signatory powers. It is stressed that the following persons cannot be appointed as signatories:

- a. the persons involved in the preparation of clients' reconciliations and
- b. the shareholders of the CIF if they do not have executive duties within the CIF.

- 34.** CySEC expects that the Chief Executive Officer or the Chief Financial Officer or the Head of the Accounting Department or an Executive Director may be the persons to be appointed as the signatories of the clients' accounts with entities of par. 4(1) of the Directive.

35. CySEC emphasizes that the clients' accounts with entities of par. 4(1) of the Directive can only be used by the CIF for its clients and not for the clients of the group that the CIF belongs to.