

CP (2016-10)

Consultation Paper of the Cyprus Securities and Exchange Commission regarding a proposed circular on the requirements for the safeguarding of clients' funds

In the context of establishing effective arrangements and procedures for consultation with market participants regarding proposed changes in the regulatory framework, the Cyprus Securities and Exchange Commission ('the CySEC') is circulating this Paper for consultation in relation to the requirements for the safeguarding of clients' funds.

The proposed circular is attached as Appendix.

The CySEC invites you to submit your comments/suggestions, in word format, by Friday 18 November 2016, to the electronic address supervision@cysec.gov.cy only.

TO : Cyprus Investment Firms

FROM : Cyprus Securities and Exchange Commission

DATE :

CIRCULAR NO. : COXX

SUBJECT : Requirements for safeguarding of clients' funds

The Cyprus Securities and Exchange Commission ('CySEC') wishes to draw the attention of the Cyprus Investment Firms ('the CIFs') on their obligations with regards to safeguarding of clients' funds and to clarify matters, in the context of establishing adequate arrangements to safeguard clients' rights. More specifically:

A. Regulatory framework

1. According to section 18(2)(j) of the Investment Services and Activities and Regulated Markets Law of 2007, as amended ('Law'), *'a CIF must, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights and, except in the case of credit institutions, prevent the use of client funds for its own account'*.
2. Part VI of CYSEC Directive DI144-2007-01 of 2012 ('Directive') specifies further the requirements for the safeguarding of clients assets.
3. For ease of reference, the abovementioned provisions are presented in Annex 1.

B. Requirement for holding separate clients' accounts

4. According to section 18(1)(e) of Directive, CIFs must ensure that clients' funds are held in accounts identified separately from any accounts used to hold funds belonging to the CIF.
5. For compliance purposes with the above, CIFs must ensure that, when opening a clients' account with a person, as it is specified in section 20(1) of Directive (hereinafter 'the Person'), in any jurisdiction, a written confirmation is obtained from that Person, stating that all funds standing to the credit of the account is held by the CIF as trustee (or if relevant, as agent) and that the Person is not entitled to combine the account with any other account or to exercise any right of set-off or counterclaim against money in that account in respect of any sum owed to it on any other account of the CIF. A relevant template will be provided by CySEC.

6. CIFs are allowed to deposit clients' funds to a Person **only when** they receive the above mentioned written confirmation. In case a CIF is unable to obtain such confirmation, it **must not** deposit clients' funds in that Person.
7. 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 sections 18(1)(e) and 20(1) of Directive (denoted as clients' accounts).
8. Having exercise the powers provided for in paragraph 18(3) of Directive, CySEC prescribes below the requirements that CIFs must apply in case the applicable law of the jurisdiction in which the client funds are held, prevent them from complying with the requirement of section 18(1)(e) of Directive (holding clients' accounts identified separately from any accounts used to hold funds belonging to the CIF):
 - i. CIFs must satisfy CySEC that they had no other alternative but to conduct such business, given the risk to clients' funds in the event of the Person's insolvency.
 - ii. 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 satisfy the CySEC on the adequacy of point (i) and (ii) above, the 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 sections 18(1)(e) and 20(1) of Directive.

C. Transferring clients' funds to another person, other than those mentioned in section 20(1) of Directive

9. In the context of facilitating clients' transactions, CIFs usually transfer clients' funds to persons, other than those mentioned in paragraph 20(1) of Directive, such as an exchange, a clearing house, a liquidity provider/market maker, or an intermediate broker. This **can only be done** if all the following conditions are applied:
 - i. The abovementioned persons are licensed/regulated in their home country.
 - ii. Clients' funds are transferred for the purposes of:
 - A client transaction through or with that person; or
 - A client's obligation to provide collateral for a transaction (for example, an initial margin requirement for a contingent liability investment).
 - iii. Before transferring clients' funds to the abovementioned persons, the CIF:
 - Notifies the person with whom the account is to be opened that the CIF is obliged to keep clients funds separate from its own funds, placing them in a client bank account.
 - Instructs the person with whom the account is to be opened that any funds paid to it in respect to that transaction is to be credited to the CIF's clients transaction account.

- Requires the person with whom the account is to be opened to acknowledge in writing that the CIF's clients transaction account is not to be combined with any other account, nor is any right of set-off to be exercised by that person against funds credited to the clients transaction account in respect of any sum owed to that person on any other account. A relevant template will be provided by CySEC.
- iv. In the case of a retail client, that client has been notified that his funds may be transferred to another person. The notification may be done through clients' terms and conditions or email or web notifications.
10. It is stressed that the initial margin of clients cannot be used as collateral with the persons mentioned in this current part when they transact on their own name or hedge their open trade positions. In case such collateral is required, CIFs must use their own funds and not clients' funds.
 11. CIFs remain ultimately responsible for the funds of their clients, irrespective of transferring them to another person.

D. Other administrative procedures

12. CIFs must exercise all due skill, care and diligence in the selection, appointment and periodic review of the person where the clients' funds are held and in the arrangements established for the holding of those funds.
13. As far as clients' accounts are concerned, CIFs must ensure that there are at least two persons with combined signatory powers.

E. Reconciliation of clients' funds

14. According to paragraph 18(1)(c) of Directive DI144-2007-01 «*a CIF is required to conduct on a regular basis reconciliations between its internal accounts and records and those of any third parties by whom those assets are held*».
15. 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.

When a CIF undertakes transactions on a daily basis, it is expected that reconciliations of clients' funds are conducted in each business day in order to ensure that funds held are equal to amounts owned to clients.

16. CIFs must ensure that reconciliations are performed between:
 - i. Clients' bank accounts or any other third party holding clients' money (as per CIF trial balance) Vs bank statements or any other third party statements.
 - ii. Client bank accounts or any other third party holding clients' money (as per CIF trial balance) Vs clients credit balances (as per CIF trial balance/trading platform).

17. The provisions of CySEC’s Circular on payment service providers (still in consultation) must be taken into account when CIFs perform clients’ funds reconciliation.

F. Reporting obligations to CySEC

18. In the context of verifying the compliance of CIFs with their regulatory obligations, CIFs must report information on clients’ funds to the CySEC.
19. Information must be reported to CySEC as follows:

| Reporting reference date | Reporting remittance date |
|--------------------------|---------------------------|
| 31 March | 10 April |
| 30 June | 20 July |
| 30 September | 10 October |
| 31 December | 20 January |

If the remittance date is a public holiday or a Saturday or Sunday, the report should be submitted on the following working date.

In order to facilitating the reporting procedure, CySEC will prepare and publish a relevant template to be filled in and submitted by CIFs.

20. CIFs must ensure that the figures related to the reporting reference date 30 June and 31 December are **verified by an external auditor** and the auditors’ verification report is submitted to CySEC within the above remittance dates.
21. CySEC will consult further with the Institute of Certified Public Accountants about the audits that need to be performed by their side. Additional information will be published in the near future, if necessary.

G. Entry into force

This circular enters into force on the notification date of this circular. As far as the existing accounts are concerned, CIFs must comply within three (3) months from the notification date of this circular.

Sincerely,

Demetra Kalogerou
Chairman Cyprus Securities and Exchange Commission

Investment Services and Activities and Regulated Markets Law

Section 18(2)(j) – «A CIF must, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights and, except in the case of credit institutions, prevent the use of client funds for its own account».

Directive DI144-2007-01 of 2012

PART VI
SAFEGUARDING OF CLIENTS ASSETS
(section 18(2)(i) and (j) of the Law)

Safeguarding of clients financial instruments and funds

18. (1) For the purposes of safeguarding clients' rights in relation to financial instruments and funds belonging to them, a CIF is required to comply with the following requirements:

(a) it must keep such records and accounts as are necessary to enable it at any time and without delay to distinguish assets held for one client from assets held for any other client, and from its own assets;

(b) it must maintain its records and accounts in a way that ensures their accuracy, and in particular their correspondence to the financial instruments and funds held for clients;

(c) it 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;

(d) it must take the necessary steps to ensure that any client financial instruments deposited with a third party, in accordance with paragraph 19, are identifiable separately from the financial instruments belonging to the CIF and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection;

(e) it must take the necessary steps to ensure that client funds deposited, in accordance with paragraph 20, in a central bank, a credit institution or a bank authorised in a third country or a qualifying money market fund are held in an account or accounts identified separately from any accounts used to hold funds belonging to the CIF;

(f) it must introduce adequate organisational arrangements to minimise the risk of the loss or diminution of client assets, or of rights

in connection with those assets, as a result of misuse of the assets, fraud, poor administration, inadequate record-keeping or negligence.

(2) . If, for reasons of the applicable law, including in particular the law relating to property or insolvency, the arrangements made by the CIF in compliance with subparagraph (1) to safeguard clients' rights are not sufficient to satisfy the requirements of section 18(2) (i) and (j) of the Law, the Commission prescribes the measures that the CIF must take in order to comply with those obligations.

(3) If the applicable law of the jurisdiction in which the client funds or financial instruments are held prevents the CIF from complying with subparagraphs (1)(d) or (1)(e), the Commission prescribes requirements which have an equivalent effect in terms of safeguarding clients' rights.

*Depositing
client funds*

20 (1) A CIF is required, on receiving any client funds, promptly to place those funds into one or more accounts, denoted as 'clients' accounts and opened with any of the following:

(a) central bank;

(b) credit institution;

(c) bank authorised in a third country;

(d) qualifying money market fund.

(2) A CIF that does not deposit client funds with a central bank, it is required to exercise all due skill, care and diligence in the selection, appointment and periodic review of the credit institution, bank or money market fund where the funds are placed and the arrangements for the holding of those funds.

A CIF takes into account the expertise and market reputation of such institutions or money market funds with a view to ensuring the protection of clients' rights, as well as any legal or regulatory requirements or market practices related to the holding of client funds that could adversely affect clients' rights.

(3) Where a CIF deposits funds it holds on behalf of a client with a qualifying money market fund, the units in that money market fund should be held in accordance with the requirements for holding financial instruments belonging to clients.

(4) The clients of the CIF have the right to oppose the placement of their funds in a qualifying money market fund.