DILLON EUSTACE

Client Asset Regulations and Guidance

Consultation Paper CP71

Introduction

Our comments/responses to Central Bank Consultation Paper 71 entitled "Client Asset Regulations and Guidance" (the "**Consultation Paper**") are set out below.

At the outset, we would point out that our comments/responses are given solely in relation to the application of the proposed Client Asset Regulations (the "**Regulations**") to Fund Service Providers ("**FSPs**") holding Collection Accounts. We do not comment on the application of the Regulations to entities which are not FSPs nor to the treatment of client assets other than clients funds held in Collection Accounts.

We have provided our answers to the specific questions raised by the Central Bank in the Consultation Paper but have not commented on the individual draft Regulations or Guidance separately as our position will be evident from our answers to the Central Bank questions and our other general and specific comments below.

General Comments

Before responding the specific questions raised by the Central Bank in the Consultation Paper, it may be of assistance for us to set out some high level comments below in relation to the application of the proposed Regulations to FSPs holding Collection Accounts, noting at the outset that we have no objection in principle to the application of client money type protections to such Collection Accounts.

Format of Regulations

Although we acknowledge that significant efforts have been made within individual Regulations to have sub-sections dealing firstly with investment firms and then with FSPs, we think that a better approach would be to have two separate and distinct Parts to the Regulations, one Part dealing with all firms other than FSPs and then a second Part dealing only with FSPs.

This would facilitate having separate definitions for FSP/Collection Accounts matters, would allow for future amendments to apply only to FSPs or all but FSPs, as the case may be, but more importantly it would in our opinion benefit both the Funds industry and the Central Bank in achieving absolute clarity as to which Regulations / Guidance apply to the Funds industry (and which do not).

If such an approach is not adopted we also fear that that the Regulations will not be adequately tailored to take account of the realities of the Funds industry nor be capable of relatively easy amendment to reflect new realities as they may arise.

Nature of Funds Subscription and Redemption Processes

Collection Accounts held in the name of FSPs are used by FSPs to deal with cash subscriptions to funds and cash redemptions from funds. They are not used for client investment instruments. We do not comment therefore on treatment of client investment instruments.

The subscription (and for that matter redemption) process for funds is governed by fund rules (contained in the Articles, Trust Deed etc.), the terms set out in the fund's prospectus and the terms set out in the fund's Application Form (which may already include a variety of disclosures regarding client funds already).

Subscriptions are made by a variety of different types of investors so that the FSP may be receiving monies directly for investors, from distributors or from other intermediaries or from correspondent bank/paying agents. Depending on the type of fund, the fund may be subject to regulatory requirements which require the appointment by the fund of correspondent banks or paying agents in other EU or non-EU jurisdictions through which retail investor subscription monies are received and redemption monies paid so that the Irish FSP may be receiving into the Collection Account monies which do not come directly from the underlying investor but rather come from another intermediary in the subscription chain.

Consideration needs to be given to these different scenarios, to who the client actually is for the purposes of the Regulations and to who that client is a client of – is he a client of the fund or of the FSP ?

Nature of Collection Accounts

If a Collection Account is an asset of the fund, we note that the Regulations do not apply.

It would be useful to set out what are the circumstance which indicate that the Collection Account is an asset of the fund – if it is an asset of the fund, does that mean that it must be in the name of the Custodian/Depositary for example ?

Consideration also needs to be given to what might be potentially different treatments for Collection Accounts which form part of a contractual settlement process as one should consider whether monies received into the Collection Account are actually client monies at all.

There may be different types of contractual settlement arrangements but, in very general terms, a contractual settlement arrangement ensures that the fund is deemed to have received the subscription monies on the Dealing Day (T) even though the investor is not required to pay for a number of days thereafter (eg T+5). This ensures that the investment manager has sufficient monies to settle portfolio purchases made in anticipation of the receipt of those pending subscriptions thereby avoiding periods of the fund being out of the market. The investor will be allocated shares as at T.

However, although the experience of investor default is we understand low, in the event that the investor does not pay and cannot be forced to pay within a reasonable timeframe, the fund sells down assets in respect of those failed subscriptions/cancels those allocations of shares, but we understand

that the fund is not left with a shortfall as the shortfall if any (ie where the value of the invested pending subscription amount falls) may be borne by the FSP.

That raises the question of whether the monies received into the Collection Account between T and T+5 in the example above should be treated as client funds at all as the investor has been allocated the shares on T (and therefore any payment by the investor of subscription proceeds from T onwards will be in respect of an investment, not *pending* investment) and the fund will be whole from T by virtue of the contractual settlement arrangement.

We also consider that further thought may need to be given to certain monies which may be held in Collection Accounts for, for example, commissions, bank charges, fx costs etc.

Collection Accounts and Redemptions

We also think that further consideration may need to be given to at what moment are monies in a Collection Account deemed to become payable to an investor in respect of a redemption as until then they may not be client monies at all. Account may need to be taken of recent cases (in Madoff related litigation) as to when the redemption process in completed as only then may the investor be deemed to have changed status for being a member to being a creditor.

Non-Irish Funds

Although we believe it to be the case – by virtue of the Regulations definition of investment fund – we feel that FSPs should be given greater clarity that the Regulations / Guidance do not apply in respect of non-Irish domiciled funds nor, for the avoidance of doubt, is an Irish FSP subject to the Regulations / Guidance in respect of Collection Accounts held by it in respect of non-Irish funds.

In some cases a Collection Account may also be used by a FSP for multiple funds (either multiple sub-funds of a single umbrella or perhaps different legal structures) and may even be used for both Irish and non-Irish funds.

Client Asset Key Information Document

We do not agree with the need to provide investors with a Client Assets Key Information Document as we consider that the necessary disclosure can be made in the Prospectus/Application Form and/or via website disclosures, and any required consents given in the Application Forms. An additional fund document is unnecessary and risks further complicating the investment process..

We do not agree with the proposed wider scope in respect of "client funds". This is because of the particular difficulty which arises in the application of the Regulations to funds where the client is defined as any person to whom a firm provides financial services. In the context of obligations imposed on a FSP, its client (i.e. the entity to whom it provides financial services) is the investment fund. The FSP's contractual arrangement is with the fund and not with the investor remitting or receiving funds.

"Ensuring"

We do not agree with the constant use of the term shall "ensure" throughout the Regulations. We do not think that a party can ensure that another party does or does not comply. It can contractually require a party to do something but to ensure is too strong a requirement and is not practical, notwithstanding its repetitive use in other regulations..

Transitional Provisions

We believe that the application of the Regulations to some FSPs may require significant changes to their systems, quite apart from the significant costs that such changes may give rise to.

Accordingly, we feel that a a transitional period of at least 24 months would be necessary for FSPs to adopt necessary technology and system changes etc.

Central Bank Questions

We have set out below our answers to the questions raised by the Central Bank

Q1 Do you agree that the Client Asset Core Principles encompass the key fundamental principles in protecting and safe guarding client assets? If not, please explain why.

1. In relation to the core principle regarding segregation, further clarity is required around the statement "for the avoidance of doubt, this principle applies to clients' assets that may be held in nominee accounts". If this is intended to mean that where a FSP which is holding client money which has been received from an entity which is acting as nominee for its clients (i.e. clients of the nominee) must treat the clients of the nominee as its clients (rather than treating the nominee entity as its client – at least for the purpose of the Regulations as a fund investor is really a client of the fund) then we believe this is incorrect.

2. In relation to designation and registration, whilst we agree that a firm should ensure that in its own records client assets are clearly identified we do not believe that it can "ensure" that in the records of external parties those clients assets are identifiable from the firm's own assets. What it can do however is contractually require that the external party clearly identifies that the assets are client assets and not the firm's own assets.

3. In relation to client disclosure and client consent, we believe that any consent to be given and any disclosure to be made as to how and where clients are held should be contained in the relevant fund Application Form and that any resulting risks therefore can be drawn to the investor's attention by means of that Application Form, or the prospectus or website disclosure. We do not believe that it is necessary in the funds context to be required to provide the investor with an additional document.

Q2 Do you agree with the proposed wider scope in respect of "client funds"? If not, please explain why.

We believe that further consideration needs to be given to this proposed widening of the scope in respect of client funds.

Firstly, the client is defined as any person to whom a firm provides financial services but in the context of obligations imposed on a FSP, its client (i.e. the entity to whom it provides financial services) is the investment fund, not the subscriber/redeemer.

Secondly, we feel that, as noted above, further consideration needs to be given as to whether monies in Collection Accounts where contractual settlement is provided should be treated as client funds at all.

Q3 Do you agree with the approach proposed to deal with instances where client funds are received but the firm has not identified the client or the necessary client paper work is not complete? If not, please explain why.

Whilst we agree that a FSP should establish a procedure to deal with monies received from a client that the FSP is not in a position to identify or where the client has submitted inadequate documentation to enable the FSP set up the account on its system, we do not believe that the prescriptive approach suggested by the Central Bank is practical.

Firstly, applying a "two business days" requirement to either identify the client or return the funds does not seem practical. It may be the case that you cannot identify the client within two business days - that may be a matter outside the control of the firm. Secondly, it may be inappropriate in certain circumstances to immediately return the funds (for example, a firm could be concerned that returning funds could be viewed itself as in some way facilitating an attempt to money launder). Thirdly, requiring a firm to seek and obtain and act upon legal advice within two business days is not realistic.

The 2 business day timeframe should be increased to a minimum of 5 business days, with added flexibility where 5 business days is not reasonably achievable.

Q4 Do you agree that the Regulation should apply to funds that have been lodged into a Collection Account? If not, please explain why.

Further consideration also needs to be given to what might be potentially different treatments for Collection Accounts which form part of a contractual settlement process as one should consider whether monies received into the Collection Account are actually client monies at all.

There may be different types of contractual settlement arrangements but, in very general terms, a contractual settlement arrangement ensures that the fund is deemed to have received the subscription monies on the Dealing Day (T) even though the investor is not

required to pay for a number of days thereafter (eg T+5). This ensures that the investment manager has sufficient monies to settle portfolio purchases made in anticipation of the receipt of those pending subscriptions thereby avoiding periods of the fund being out of the market. The investor will be allocated shares as at T. However, although the experience of investor default is we understand low, in the event that the investor does not pay and cannot be forced to pay within a reasonable timeframe, the fund sells down assets in respect of those failed subscriptions/cancels those allocations of shares, but we understand that the fund is not left with a shortfall as the shortfall if any (ie where the value of the invested pending subscription amount falls) may be borne by the FSP.

That raises the question of whether the monies received into the Collection Account between T and T+5 in the example above should be treated as client funds at all as the investor has been allocated the shares on T (and therefore any payment by the investor of subscription proceeds from T onwards will be in respect of an investment, not pending investment) and the fund will be whole from T by virtue of the contractual settlement arrangement.

We also think that further consideration may need to be given to at what moment are monies in a Collection Account deeded to become payable to an investor in respect of a redemption as until then they may not be client monies at all. Account may need to be taken of recent cases (in Madoff related litigation) as to when the redemption process in completed as only then may the investor be deemed to have changed status for being a member to being a creditor.

Q5 Do you agree for the purpose of segregating client assets and determining which clients are impacted if a third party fails, a firm should be able to identify where each individual client's assets are held? If not, please explain why.

The FSP should be able to identify in its own records which clients (i.e. subscribers / redeemers) funds are held at which third party entities.

Q6 Do you agree that a client's required margin should be better protected under the client asset regime? If not, please explain why.

Not applicable in the Funds context. .

Q7 Do you agree that the records should be retained for six years? If not, please explain why.

Yes.

Q8 Do you agree with the new approach proposed in respect of Facilities Letters and Confirmations? If not, please explain why.

In principle yes.

Q9 **Do you agree that in the interest of protecting client assets, where a third party has not designated a client asset account/Collection Account as requested by the firm, these client assets should be withdrawn from the third party without delay? If not, please explain why.**

Yes. However we do not see that this should really arise in practice.

Q10 **Do you agree with the approach for reconciling client asset accounts that hold client funds? If not please explain why. If there are other types of accounts that do not readily conform to the frequency of reconciliations cited above, please provide details of same.**

We agree that the frequency of the reconciliations should be determined by the frequency of the transactions going across the accounts and that in any event such reconciliations should be performed at least monthly, or more frequently for daily dealing funds.

However, it may not always be possible to obtain a statement from the third party in order that the reconciliation can be performed by close of business on the day following the business day to which the reconciliation relates – particularly for accounts which have very infrequent transactions and for which a statement may only be available on an infrequent basis.

We would suggest that the reconciliation is performed within 1 day of receipt of the statement of account from the third party provided that the third party sends the statements to the firm within a reasonable period of time after the business day to which the reconciliation relates.

Q11 **Do you agree that the client financial instruments should be reconciled at least monthly or should the reconciliation be performed in a lesser time period? If so, please explain why.**

Not applicable in funds context.

Q12 **Do you agree with the time allocation of ten days to complete these reconciliations or should it be performed in a lesser time period? If so, please explain why.**

Not applicable in funds context.

Q13 **Do you agree that an investment firm should immediately make good or provide the equivalent of any shortfall in client financial instruments? If not, please explain why.**

Not applicable in funds context.

Q14 **Do you agree that a Collection Account should be reconciled each time a transaction occurs on that account? If not, please explain why.**

At the end of each day on which a transaction occurs.

Q15 Do you agree that it is appropriate for a firm to report material reconciling items with the level of materially determined by the firm? If not, please explain why.

Yes but suggest further industry discussion would be of assistance in determining what should be considered material.

Q16 Do you agree with the components of an investment firm's Client Money Requirement and Client Money Resource? If not, please explain why.

Not applicable in funds context.

Q17 Do you agree with the Central Bank's approach to the computation of the Client Money Requirement and Client Money Resource for FSPs? If not, please explain why.

We feel that consideration of this matter should wait until there is further clarity on treatment of contractual settlement type arrangements for subscriptions and when monies are deemed to become client monies for redemptions.

We also consider that further thought may need to be given to certain monies which may be held in Collection Accounts for, for example, commissions, bank charges, fx costs etc.

Q18 Do you agree that a firm's Client Money Resource should only contain what it is required to hold for its clients on a given day? If not, please explain why.

We feel that consideration of this matter should wait until there is further clarity on treatment of contractual settlement type arrangements for subscriptions and when monies are deemed to become client monies for redemptions.

We also consider that further thought may need to be given to certain monies which may be held in Collection Accounts for, for example, commissions, bank charges, fx costs etc.

Q19 Do you agree that the reporting of an investment firm's Client Money Resource shortfall should be investment firm specific based on its materially appetite? If not please explain why.

Not applicable in funds context.

Q20 Do you agree that a statement should be provided on an annual basis or should it be provided on a more regular basis?

Not applicable in funds context.

Q21 Do you agree that (a) to (g) above will provide clients with sufficient information regarding their holdings? If not please explain why, providing details of additional information which should be included.

Not applicable in funds context.

Q22 Do you agree that a Fund Service Provider should issue a receipt to the client? If not, please explain why and put forward an alternative approach that will provide confirmation to a client that his/her money is deposited in a Collection Account.

No. The existing contract note issuance is sufficient.

Q23 Do you agree that an investment firm should seek prior written consent from its clients in respect of the circumstances listed in (a) to (h) above? If not please explain why, providing details of additional circumstances which should be included.

Not applicable in funds context.

Q24 Do you agree that a FSP should obtain prior written consent from a client in respect of the circumstances listed in (a) to (c) above and with the medium used to obtain this consent? If not please explain why, providing details of additional circumstance which should be included.

We consider that these consents can be obtained via the Application Form but again whether they are required will depend on whether the monies are client funds in the first place.

Q25 Do you agree that the CAKID will better inform the client with a greater understanding providing information in clear plain English that will equip the client to comprehend where and how his/her assets are held when deposited with a firm? If not please explain why.

In the funds industry context we feel that another document (on top of prospectus, KIID, Application Form etc) will only serve to confuse. Disclosure via the Application Form with cross references potentially to a website disclosure should be the most required.

Q26 Do you agree with the need to provide the CAKID to both existing and new clients distinguishing clients of an investment firm and a Fund Service Provider as outlined above? If not please explain why.

No.

In the case of existing investors, any required disclosure (we do not agree with the CAKID in the first place) could perhaps be included with next annual financial statements (or by a highlighted cross reference in those financial statements).

Q27 Do you agree with appointing a person to the role of CAOR which will be a pre-approved controlled function? If not, please explain why?

Yes but needs to be capable of being fulfilled by a holder of another PCF position such as Compliance Officer. Should not require a new hire.

We do not however agree with the requirement that the COAR be a director. Why should that be a requirement when Head of IA or the Compliance Officer does not need to be ?

Q28 Do you agree with the responsibilities of the Client Asset Oversight Officer as provided for in (a) to (g) above? If not, please explain why, providing details of additional responsibilities which should be included.

Generally yes but only on assumption that the CAOR can utilise colleagues to assist.

Q29 Do you agree with the purpose of the CAMP and the minimum that should be included in this document? If not, please explain why, providing details of additional records which should be included.

In principle yes.

Q30 Do you agree that Regulation 8(3) provides for what should be included in a CAE? If not please explain why.

Yes but we also point out that we do not see why the firm has to ensure that the external auditor has the necessary skillset. Should that not be for the external auditor to demonstrate ?

Q31 Should this review be carried out more frequent than annually? If so, please explain why.

No.

Q32 Do you agree with the type of assessment that should be carried out on the firm's initial CAMP by an independent external expert?

Mandating the use of an independent external expert is an approach that will not always be warranted and should be reconsidered. The proposal will create additional expense for firms and will not always be necessary given that the Central Bank will have oversight of the CAMP.

Q33 Do you agree that 3 months is sufficient time for a firm to obtain an assessment of the CAMP from an independent external expert? If not, please explain why.

We do not know. This will only be determined based on actual experience.

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