
TO : **Cyprus Investment Firms**

FROM : **Cyprus Securities and Exchange Commission**

DATE : **27 November 2020**

CIRCULAR NO : **C418**

SUBJECT : **Enhancement of procedures regarding safeguarding of client funds held by CIFs**

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 par. 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 par. 4(1)(e) of the Directive (i.e. denoted as clients' accounts).

6. Having exercise the powers provided for in par. 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 par. 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 par. 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 point 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 point 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 point 9 above only if it is licensed to provide the ancillary service of par. 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/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 par. 6(1) of Directive.

12. CIFs' merchant accounts must not, under any circumstances, be used by their connected persons, or third persons, and/or the clients of those persons, for the clearing/settlement of their payment transactions, as this does not comply with the relevant provisions of the legislation. Merchant accounts must be used only and exclusively by CIFs.
13. The CIF must exercise all due skill, care and diligence in the selection, appointment and periodic review of the PSP/EMI with whom merchant accounts are maintained. CIFs may be considered that they have taken every possible measures and introduced adequate organisational arrangements to protect their clients' funds, only if they maintain a merchant account with PSP/EMI which are licensed/regulated by a competent authority of a Member State or of a third country, which it is considered that it imposes equivalent arrangements to those of the European Union and in particular, to those of the European Directives 2005/06/EC1 and 2007/64/EC2.
14. For purposes of transparency and full information of investors, CIFs are requested to post on their websites a list with the names of the PSP/EMI they cooperate, as well as the competent authority/country that supervise them.

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

15. 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.
16. 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.
17. 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.
18. 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

19. According to par. 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.
20. 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 par. 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.
21. CySEC considers that a CIF in the context of complying with its obligation to periodically review its initial assessment it should undertake:
- 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;
 - a review at least when a year has elapsed since its previous assessment.
22. 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:
- €3.000.000
 - 50% of the total clients' funds held by the CIF.
23. Where the threshold stated above has been exceeded due to circumstances not attributable to the CIF's actions or omissions such as a money transfer by a client, dividend, coupon or other income payments, interest payments derived from a bank account the CIF shall take immediate action to reduce the balance with bank or money market fund of the same group as the CIF within the allowable limit.

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

24. CIFs are not entitled to:
- 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.
 - 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 par. 8(3) of the Directive.

G. Maintaining a 'buffer' in clients' bank accounts

25. 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.
26. 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.
27. For this purpose, when a CIF decides to maintain a 'buffer' per point 25 above, the CIF must establish a written policy that is approved by its 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

28. 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.
29. 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.
30. The single officer is expected to verify the accuracy and completeness of the clients' money reconciliation that is included in CySEC's QST-CIF Form (ie. Reconciliation Tab).
31. 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

- 32.** According to par. 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*».
- 33.** 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.
- 34.** When a CIF undertakes transactions for its clients on a daily basis, CySEC expects that reconciliations of clients' funds will be conducted on each business day on the records of the CIF as at the close of business of the previous business day.
- 35.** CIFs must ensure that reconciliations are performed between:
- Clients' bank accounts or any other third party holding clients' funds (as per CIF records) Vs bank statements or any other third party statements.
 - 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.

- 36.** The internal auditor and the compliance officer of a CIF during their annual work plan are expected to review the procedures maintained by a CIF for the safeguarding of its clients' assets per Part I of the Directive, which includes among other the verification of the accuracy and completeness of the clients' money reconciliation.

If a significant weaknesses/issue is identified by the internal auditor or the compliance officer then they should report it to Board of the Directors of the CIF immediately in order to take immediate corrective measures.

J. Other matters

- 37.** 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:
- the persons involved in the preparation of clients' reconciliations and
 - the shareholders of the CIF if they do not have executive duties within the CIF.

- 38.** 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.
- 39.** 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.

Yours sincerely

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