

**PS 14/9 Review of the client
assets for investment
business
BEST PRACTICE STATEMENTS**

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1. Introduction

Purpose of the Document

The Best Practice Statements are a guide to TISA members in connection with the requirements of PS14/9. The information contained within these statements is for informational purposes only and is not intended as a substitute for the need of each firm to understand the CASS requirements and determine its own CASS policies and procedures that are relevant to its business. The information contained is for general guidance only, is not exhaustive and may change from time to time.

Following permission, extracts to help form this document have been taken from the TA Forum Best Practice document, please refer to www.thetaforum.co.uk/cass/ for the TA Forum document in its entirety.

The FCA published Policy Statement PS14/9: Review of the client assets regime (“PS”) for investment business on 10 June 2014. The PS changes have/are taking place in the following three phases:-

1 July 2014

Certain rules and guidance came into force which provided clarification of existing requirements. These included limiting the placement of client money in new unbreakable term deposits and the introduction of the option to operate multiple client money pools.

1 December 2014

Rules and guidance came into force on the provision of information and consent obligations when entering into custody agreements with new investors and the documentation of agreements and arrangements with any new counterparties with whom firms deposit or otherwise place custody assets or client money. These new obligations included a requirement to notify the investor of certain matters if operating under the banking exemption and mandating the use of template acknowledgement letters with new client bank and client transaction accounts.

1 June 2015

All of the remaining rules and guidance came into force and all regulated firms were required to be fully compliant.

This document provides TISA best practice in respect of the key changes outlined in the PS which affect the administration activities performed by regulated firms.



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2. Cass 6 – Custody Asset Rules

2.1 Custody recordkeeping, record checks and reconciliations

Rule(s): 6.6 – Records, accounts and reconciliations

Rules have been updated to accommodate firms that use integrated systems to maintain their records for custody assets; the amended rules also introduce a minimum frequency at which firms are required to undertake reconciliations or perform other checks to ensure the accuracy of their records for custody assets.

Before deciding on the most suitable method of reconciliation, a firm must decide the most appropriate method of custody asset record check for the business operated. The methods are:

Internal Custody Reconciliation Method - where client specific and aggregate level holdings are maintained independently. These two sets of holdings can be compared against each other in order to identify any differences. This could include a situation where two sets of data are maintained on the same system, but are generated from two independent sources or separately updated from the same source.

Internal System Evaluation Method - where the client specific and aggregate level holding are not maintained independently of one another, or where there is only one record rather than two.

As the data source for the information is not independently maintained in two separate records, the firm must be able to evidence adequate checks and controls to ensure that the transactional information is being input and maintained correctly to ensure no errors occur on client level holdings and at the aggregate level.

It is critical that the firm, who as the regulated entity ultimately own the process, must ensure they have an appropriate level of understanding and oversight in place, particularly if a TPA has been engaged.



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As per 6.6.19 R, the internal system evaluation method requires a firm to:

(1) Establish a process that evaluates:

(a) the completeness and accuracy of the firm's internal records and accounts of safe custody assets held by the firm for clients, in particular whether sufficient information is being completely and accurately recorded by the firm to enable it to:

(i) comply with CASS 6.6.4R; and

(ii) readily determine the total of all the safe custody assets that the firm holds for its clients;
and

(b) whether the firm's systems and controls correctly identify and resolve all discrepancies in its internal records and accounts of safe custody assets held by the firm for clients;

(2) Run the evaluation process established under (1) on the date of each internal custody record check; and

(3) Promptly investigate and, without undue delay, resolve any causes of Discrepancies that the evaluation process reveals.

The checks performed by the firm in order to meet the requirements of the Internal Systems Evaluation method may take place daily, weekly or monthly as appropriate to that particular check. However the overall evaluation of the outcome of these checks, constituting the formal evaluation required by the CASS rules, should be consolidated and evaluated by the CF10a at least monthly. This formal evaluation should be clearly evidenced and the outcome and subsequent actions documented.

The evaluation should ensure that the firm meets the requirements of 6.6.19 R, there are a number of steps that can be taken to provide the assurances to auditors and the regulator that the ISEM process they employ is robust, credible and accurate. A number of best practice examples of areas of focus are provided below. In each case, evidence is required, to prove that the controls and processes are working so as to provide assurance as to the completeness and accuracy of asset records.

Documentation

Overview of firm's process

Firms should consider producing an over-arching document detailing how the control check is completed along with the controls around the process. This would also reference any supporting documentation and governance to provide auditors with a consolidated view of the ISEM process. This documentation can then be used to identify the key controls, the evidence of which will need to be evaluated as part of the ISEM.



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Risk Assessment

A detailed formal risk assessment of the ISEM process, including the control check and surrounding documentation would help provide both internal governance and external auditors that the system and reporting used by the firm is robust and fit for purpose.

The risk assessment should assist firms in identifying any further mitigations required and in further defining the key items to be evaluated as part of the ISEM.

Process Maps

Firms may also consider producing process maps detailing each step taken (both systemically and manually) from the arrival of the client's application form, to the completion of the internal control check. By producing this map, it allows firms to work through the entire process and identify any flaws in controls.

This will then ensure that any issues are documented and remediated. Evidence of this may also form part of the ISEM.

Procedures

Operating procedures should form the core of all firm's documentation, covering in detail each step of the key processes and the individual responsibilities of the firm's employees in completing the primary tasks to ensure the client receives the correct asset.

Operational Controls

Details around operational controls would supplement procedures by detailing end of day tasks, sample checking of daily entries and any checklists uses to ensure all tasks have been completed. This could include queue monitoring and reviewing negative balance reports.

Systems and IT

Access

This must be viewed at 2 levels:

The access of individuals who perform functions (input and verification)

The access of IT staff who could potentially amend records

Controls around individual access and system security (in particular standing data controls) must be clearly defined within a firm's policies and operating procedures. Evidence will be required to show that these controls have been effectively applied.



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Testing

Firms could consider creating and carrying out a series of business scenarios to establish whether the core system could move into a negative position. This would then allow the firm to identify these in procedures and either generate a system change or introduce appropriate controls to ensure processors do not allow this to happen.

Details of this approach, including results and mitigating actions, should be documented within the firm's risk approach.

Evidence of the performance and results of such testing should be included in the Internal Systems Evaluation.

System Changes

Any system changes that are carried out during the course of a year to processes that will ultimately impact custody assets must have sufficient regression testing completed (which should also include the test scenarios described above).

Details of such testing must be included in the formal project documentation and can be made available to auditors to prove out system reliability.

Where any changes to the system are in progress or have taken place within the evaluation period, evidence showing these elements should be considered as part of that evaluation.

Governance

Evidence of strong governance within each firm is vital to add credibility to processes and supporting documentation. To that end, all of the subjects covered above (if used) should be documented and ratified by the firm's appropriate body.

It would be preferable for a firm to delegate the responsibility of ratification to a CASS governing body or equivalent. Providing this has senior representation from the key areas within the business such as Risk and Compliance, it will ensure that the documents presented to it to review the ISEM process get approval from a group with the appropriate knowledge and experience. The final assessment and sign off of the ISEM evaluation should be performed by the CF10a.

Any meetings of this body must have supporting minutes to provide assurance to the regulator and auditors that the firm has robust governance around the ISEM process and can react and influence the key areas within the business when issues arise.



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Frequency of the custody record checks

When determining the frequency at which it will undertake its internal custody record checks under CASS 6.6.11R, physical asset reconciliations under CASS 6.6.22R, and external custody reconciliations under CASS 6.6.37R, a firm must have regard to: (1) the frequency, number, value and pricing of transactions which the firm undertakes in respect of clients' safe custody assets; and (2) the risks to which clients' safe custody assets are exposed, such as the nature, volume and complexity of the firm's operating model.

As noted above, the underlying checks may take place daily, weekly or monthly. It is the formal evaluation which should be consolidated and evaluated at least monthly.

External custody reconciliations must be carried out as regularly as is necessary, but at least on a monthly basis. A review by the firm of the frequency of the custody record check must be undertaken on an annual basis.

2.2 Recordkeeping and notifications

Rule(s): 6.6 – Records, accounts and reconciliations

Enhanced rules have been introduced relating to recordkeeping requirements. Firms are required to make and retain copies of each custody record check and/or reconciliation the firm undertakes, each review it conducts of these arrangements and its policy and procedures for complying with the FCA requirements, including those around recordkeeping and reconciliations. The requirements of CASS 6.6.8 must also be met:

For each internal custody record check, each physical asset reconciliation and each external custody reconciliation carried out by a firm, it must make a record including:

- (1) the date it carried out the relevant process;
- (2) the actions the firm took in carrying out the relevant process; and
- (3) a list of any discrepancies the firm identified and the actions the firm took to resolve those discrepancies.

Where a firm will be unable to comply with a specified requirement, either continuously or for a specified period, or where the firm materially fails to comply with a rule the firm will be required to notify the FCA. Materiality thresholds will apply to actual breaches in some cases, meaning not all breaches need to be notified to the FCA. What is material will depend on the circumstances and firms will need to consider this on a case-by-case basis.

Internal records must be maintained, as noted above, for arrangements, policy and general CASS governance.



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As part of internal rationale and documentation, a firm should record the following:-

- i) each review it makes of arrangements
- ii) policies and procedures incl. record keeping and reconciliations
- iii) materiality thresholds

2.3 Handling discrepancies and shortfalls in custody assets

As per CASS 6.6.48G, any discrepancy that is identified must be recorded in the firm's books and records and fully investigated. It must not be considered resolved until it has been fully corrected. Discrepancies must be resolved without undue delay and must include appropriate steps with regards to treatment of shortfalls.

Breaches in relation to discrepancies – these will potentially occur in the following circumstances:

- Shortfall not funded in the appropriate timescales
- Incorrect firm's record (including misleading narration)
- External reconciliation discrepancies not cleared within an appropriate timescale where all required data has been received
- Internal custody record check discrepancies not cleared within an appropriate timescale where all required data has been received
- Plus other items per CASS 6.6.57 including failure/material failure to complete external reconciliations or internal custody record checks.

Firms must determine what would constitute a breach in relation to discrepancies within its business. Factors for consideration would be:

- Frequency of reconciliations
- Reliance on external parties
- Materiality
- Information received

Each firm must also determine within their own policies and rationale what would be an 'appropriate' timescale for a discrepancy to be cleared or a shortfall to be funded.

Funding of Stock Shortfalls

The new rules (6.6.54 R) clarify the obligation on firms to fund shortfalls for custody assets in relation to discrepancies only for which they are responsible.



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Firms should deal with each discrepancy on a case by case basis, and they must have documented policies and rationale which will include when a shortfall must be funded and when a client should be notified of an error. The final decision on whether to contact a client should comply with the firm's own governance process and is likely to be the CF10a.

If the discrepancy cannot be resolved a firm will need to make good the shortfall with its own assets or cash equivalent as part of the daily client money reconciliation as soon as it has been identified, including when identified on the internal or external custody reconciliation, or via independent notification from the external source i.e. custodian.

Examples of asset shortfalls would include:

- Purchasing of an incorrect asset if considered a custody break requiring funding
- Failed Trades – only where it has contractually settled on the client's side
- Duplicate Transfer Out
- Shortfall in a Global Omnibus account – if the UK entity is affected by a foreign entity, the UK position must be made good.

Where it has been established that the firm is not responsible for the discrepancy, it is not mandatory for shortfalls to be funded. However, as per 6.6.54 (3), firms must seriously consider if this would be appropriate. Any consideration must also take into account timing differences, particularly where there is a delay in updating internal records.

Impact on Client Money Reconciliations and CMAR

When funding a shortfall using the firm's own cash, firms should represent the amount funded in both the resource and requirement. The amount funded should have a record backing it up with reference to the underlying clients that the funding relates to. The method and detail of this record will depend on the individual firm's processes.

As a result of funding using firm's cash it will potentially have an effect on the CMAR. An element of double counting will arise as the asset position and cash position recorded per the CMAR is the amount per the firm's records. This must be clearly documented in the firm's documentation as back up to the CMAR.

Use of Firm's Own Assets

In order to deal with shortfalls, firms can, as per CASS 6.2.5R hold a small balance of assets for operational purposes, providing they are clearly identified separately from the client's safe custody assets within the firm's records.

Clear guidance is provided in respect of the scenarios where these assets can be used under CASS 6.2.6G.



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Where a firm uses its own assets to make good the shortfall, it must ensure that it uses an *appropriate asset* or the equivalent value of a different asset to cover the shortfall, update the books and records in a manner that clearly identifies the asset(s) as belonging to the client and ensuring this is reversed when the discrepancy has been corrected.

Use of Firm's Own Money

When covering a shortfall using a firm's own money or an asset different to that in which the shortfall arose, a firm will have to revisit the valuation each day to ensure it is segregating the right amount of client money or assets. Where a firm concludes that another person is responsible for the discrepancy, it will need to take all reasonable steps to quickly resolve the situation with the relevant party. It will not be required to fund the shortfall but may choose to do so.

Clearance of Discrepancies

Where a discrepancy identified through the firm's external reconciliation is funded either through the use of firm's cash or stock, this cannot be considered resolved until either:

- 1) The completion of the next external reconciliation, ensuring that both the firm's and the 3rd party records correspond. This must be reflected when aging discrepancies within the firm's reconciliation and records.
- 2) Firms can seek earlier confirmation of resolution, however this must be received in writing and reflect that the discrepancy *has been* resolved, as opposed to *being* resolved. An example of appropriate confirmation from the 3rd party would be a statement extract or confirmation of daily movement that reflects the resolution i.e. a screen shot such as the 'messaging' screen within Crest. The evidence must be suitable and robust.

Any correction of custody asset shortfalls must take into account any distributions or corporate actions that have taken place during the correction process.



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Notification of Clients

There is a requirement under CASS 6.6.54 R (3) for firms to consider whether to contact clients in the event of a custody asset discrepancy.

When deciding if a client should be contacted, firms must consider at least the following:

Type of error

If the error is straightforward, regardless as to whether funding is required to cover any shortfall, and is in the process of being remediated, there may be no requirement to contact the client.

If the error is complex and a lengthy delay is possible, or if the issue cannot be resolved for any reason, such as unavailability of the appropriate asset due to suspension, firms should consider contacting the client to make them aware of the issue.

Materiality

Materiality can be interpreted a number of ways, and could include the length of time that a discrepancy has been outstanding, the value of the discrepancy (i.e. large in size), the number of clients affected by the discrepancy and as above, whether the issue can be remediated easily.



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2.4 CASS 6 Due Diligence

Firms can be subjected to this requirement both when acting as a custodian and also when contracting with a custodian as part of their custody asset process.

Due diligence will be undertaken as part of contractual negotiations when a new custodian is being sought, but also on a regular basis as part of the developing relationship between the firm and custodian, usually annually.

As a matter of best practice, the over-arching responsibility for this process should lie with the CF10a of the Custodian or equivalently responsible individual, where the Custodian has no CF10a. While the process will inevitably involve a number of areas and individuals across the business, the CF10a must retain overall control as it is a CASS responsibility.

The following is a list of suggested elements for firms to use when either approaching a Custodian to perform initial/on-going due diligence, or to enable preparation should they, as a Custodian, be approached by a firm requesting to perform due diligence. These are in addition to those items mandated by CASS 6.3.

CF10a oversight of business – this will allow firms to understand the role the CF10a plays at the custodian, including committees, project oversight, regulatory change and decision-making. Note – if the custodian resides overseas, the CF10a role will not exist.

Financial stability – while the evaluation should focus on the financial position of the contracting legal entity, the interaction with other group members may be useful. For example, does the custodian form part of a larger entity providing greater financial support? When reviewing, items such as cash flows, credit ratings and adverse indicators should be considered.

Operational processes – what documentation does the custodian have in place? Are the procedures sufficient and provide comfort that appropriate controls are in place to safe guard assets as per CASS 6.3.2?

Regulatory – how are regulatory changes dealt with? Are there sufficient policies and rationale in place to meet the existing CASS rule requirements? Any FCA fines should be reviewed and concluded on.

Governance – is there appropriate governance with the custodian? How effective is the CF10a in performing the role? Do all the encompassing elements of the business receive sufficient oversight and support?

Contingency – does the custodian have a sufficient and compliant resolution pack process in place? Is there a robust disaster recovery plan available?

Training – what CASS training is carried out across the business? Who receives it, how frequently is it refreshed and how is this monitored and measured?



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Employees – what are the skill sets of the employees in key positions? What qualifications do they have?

3. CASS 7 Client Money

3.1 Client money record keeping and reconciliations

The rules establish clear requirements as to the steps a firm is expected to follow when undertaking an internal client money reconciliation for (a) 'standard method'; (b) clarifying the circumstances in which a firm is able to undertake a non-standard method of internal client money reconciliation (which requires the firm's auditor's assurance); (c) mandating the minimum frequency at which firms should undertake client money reconciliations (both internal and external); and (d) introducing more detailed notification and recordkeeping requirements.

Firms must ensure record keeping and notifications requirements are met, ensure procedures and documentation are maintained and reviewed, ensure the firm (and auditors/the FCA, where applicable) has endorsed the method of internal reconciliation, ensure discrepancies are dealt with in line with appropriate rules and the firm SLA, ensure that the new requirement to produce consolidated client entitlement lists within 2 business days can be met when required (7.15.6G), ensure daily client money reconciliations and calculations can be produced, controlled, reviewed and validated. This requirement should be tested by firms annually.

Method of internal client money reconciliation

The regulator has permitted the continued use of the net negative add-back method for firms that fall within the appropriate criteria. In respect of the client money requirement, the FCA has increased the prescription of the components that must be used to calculate this position. The individual client balance method has been retained but can be completed at a product level. The basis of this method is unchanged.

CASS 7.16.17 R (1) states the starting point for the requirement when using the net negative add back method must be 'the amount which the firm's internal records show as held in that account'. As this figure must come from an internal source, this can be reflected by using the cashbook.

An offset of any negative amount should then be taken into account as per 7.16.17 R (2) as part of the requirement calculation. This should represent the value of ALL clients in a net negative position, not just clients relating to the specific day's transactions.

The aim of the internal client money reconciliation is to compare the resource against the requirement to ensure the accuracy of the firm's books and records. In the net negative add back process described above, the resource figure is being used in both cases. This process does not identify the individual clients to which the money belongs.



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It is necessary, under CASS 7.16.18 G (1) that firms utilising this method of reconciliation must ensure that the individual client balances can be recognised as part of this process. To ensure this occurs, a reconciliation has been introduced which details all clients who hold client money within the bank account being reconciled, as per separate books and records, and this is reconciled back to the requirement figure from the internal client money calculation.

An alternative to the above is to use the individual client balances to form the requirement position. While this is closer to the Individual Client Balance method, it does provide a true reconciliation to the resource position, and therefore the Internal Control Check would not be required.

This would involve using all the records that contain client balances, either through ledgers or reports, to check the balance of the requirement. This would then be reconciled against the resource which would be populated independently. Any genuine record keeping errors can then be driven out and corrected.



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Example of Net Negative Add Back Calculation

<u>Internal Reconciliation</u>			
<u>As At Date:</u>			
		Amount	
<u>Client Money Resource</u>		<u>1,000,000.00</u>	
<u>Client Money Requirement</u>			
Amount Held on Account		1,000,000.00	Resource Figure
Offset in respect of negative client balances		0.00	
<u>Total Client Money requirement</u>		<u>1,000,000.00</u>	Reconciled with Control
<u>Internal Control Check</u>			
Alternative Approach Mandatory Prudent Segregation Amounts		500,000.00	
Unallocated Client Money Where Not Already Included		300,000.00	
Unidentified Client Money Where Not Already Included		100,000.00	
Money at Thrid Parties, where applicable.		50,000.00	
Prudent Segregation		50,000.00	
Cheques Received Not Yet Banked, Where Already Posted		0.00	
		<u>1,000,000.00</u>	Reconciled with Requirement
<u>Completed By :</u>			
<u>Checked By:</u>			



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Example of Individual Client Balance Calculation

Internal Client Money Reconciliation Example		ABC Plc	
As At:		22-Oct-2015	
Report Generated:		23-Oct-2015	
Reporting Currency:		GBP	
CLIENT MONEY CALCULATION			
Client Money Required (Requirement)			
Client Free Money (This is uninvested client money held by the firm (no trades) and may exclude negative balances as in many instances firms will use a net positive balance)	A		980,000.00
Sales delivered by client unpaid to client (a - in respect to principal deals when the client has delivered the designated investments; and, b - in respect of agency deals, when either; (i) the sale proceeds have been received by the firm and the client has delivered the designated investments; or, (ii) the firm holds the designated investments for the client) (May also be defined as or separately categorised as Fund Sales/Buys delivered by client or unpaid to client)	B		0.00
Purchases paid by client undelivered to client (The cost of purchases: a - in respect of principal deals, paid for by the client but the firm has not delivered the designated investments to the client; and, b - in respect of agency deals, paid for by the client when either; (i) the firm has not remitted the money to, or to the order of, the counterparty; or, (ii) the designated investments have been received by the firm but have not been delivered to the client;) (May also include Fund Distributions received unpaid to client)	C		0.00
Less: Purchases delivered to client unpaid by client (money owed by the client in respect of unpaid purchases by or for the client if delivery of those designated investments has been made to the client; and, Proceeds remitted to the client in respect of sales transactions by or for the client if the client has not delivered the designated investments)	D		0.00
Unpaid fees e.g. to affiliate ABC's Sister Plc (May include any unpaid fees held by the firm on behalf of the client that are required to be paid away)	E		(1,000.00)
Negative Client Money Balances (May be included if the Client Free Money does not exclude these)	F		1,000.00
Unallocated Client Money (May also include Income received not allocated to clients; and, Trade Settlements not processed to clients)	G		1,500.00
Unidentified Client Money (If this is not already included in other ledgers in the calculation)	H		1,000.00
Prudent Segregation Amount (Normal approach firm prudent segregation amount as per 7.13.41R)	I		20,000.00
Asset Shortfall Funding Adjustment (May include negative assets funding, asset shortfall funding, external reconciliation shortfall funding)	J		0.00
Cheques Issued not cashed (Outstanding client money cheques that have been issued but not cashed by the client)	K		0.00
Total Money Due To Clients / Requirement	X = A + B + C + D + E + F + G + H + I + J + K		1,002,500.00
Client Money Held			
Cash Book 1 Total	Y1		250,000.00
Cash Book 2 Total	Y2		250,000.00
Cash Book 3 Total	Y3		250,000.00
Cash Book 4 Total	Y4		250,000.00
Debitcard funds not yet received	Y5		0.00
Total Money Held For Clients / Resource	Y = Y1 + Y2 + Y3 + Y4 + Y5		1,000,000.00
Difference (Funding required)	Z = X - Y		2,500.00
Client Money Excess / (Shortfall)			2,500.00



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3.2 Client money reconciliation discrepancies

While the rules around client money reconciliation discrepancies have not changed with the introduction of PS14/9, it is important that firms interpret this subject correctly.

There are two recognisable types of client money discrepancy:

- Cash
- Record Keeping

Cash

Cash discrepancies occur as a result of a shortfall or excess within the client money account. This could be the result of a processing error, or an expected event occurring such as a bank charge or a value that has been paid from an external source incorrectly.

When a discrepancy arises as a result of the internal client money reconciliation (CASS 7.15.29R) the rules require a firm to fund a shortfall with the firm's own money, or remove any excess to a non-client money account, by close of business on the day the reconciliation is performed.

When a discrepancy arises as a result of the external client money reconciliation (CASS 7.15.31R) the rules require that, unless the discrepancy arises solely as a result of timing differences, a firm takes all reasonable steps to correct it without undue delay. While a firm is unable to immediately resolve a discrepancy which indicates a shortfall in the bank account identified by an external client money reconciliation (CASS 7.15.32R), the firm must, until the matter is finally resolved, pay its own money into a relevant account.

A shortfall or an excess may not be considered a breach, providing the discrepancy is corrected within the prescribed timescales.

Record Keeping

Record keeping errors occur where a firm's books and records do not accurately reflect the values within the client money bank account, other than as a consequence of the timing differences allowed for under 7.15.32. This will ultimately lead to an incorrect client money requirement and misleading individual client balances.

This might occur where a firm relies on journals to process entries through their books and records.



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In keeping with rule 7.15.3 R which states that a firm must 'ensure' accurate records, breaches must be raised upon discovery of record keeping errors. In addition the immediate notification of the breaches set out in CASS 7.15.33 must be borne in mind.

It is important to keep any errors in context, particularly if a firm processes large volumes of journals.

Details of Correction

In cases involving either cash or record keeping errors, it is vital that firms record for each error what has happened, why the error occurred, what actions have been taken to correct the error and what has been done to avoid a future repetition.

Individual Discrepancies

There are three categories that relate to all discrepancies which are particularly important for CMAR purposes. It is vital that firms can place items within their books and records into one of the following:

- Unidentified – The firm cannot identify who the value belongs to, including where it is not certain whether the money is client money or firm's money. On completion of a thorough investigation, this value should be returned with 10 business days, if possible, as a matter of best practice.
- Unallocated – An amount has been received correctly but cannot be allocated to clients. An example would be a bulk distribution payment that has been received early. Allocation must take place within 10 business days, in accordance with CASS 7.13.36(1)
- Allocated – An amount that has been received and has been clearly narrated in the firm's books and records as belonging to a specific client. This could include allocation within a firm's system, depending on how client money is held.

3.3 Intra-Day Shortfalls

Intra-Day Policy

It is imperative for a firm, however it chooses to manage its intra-day risk, to have a documented policy that is approved by its Board and is reviewed on a regular basis.

The policy should include a risk assessment, methodology for determining the values required, rationale and review period which will allow auditors and the regulator to understand fully the firm's approach.



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Through PS14/9, the FCA have reinforced their stance for firms to ensure that one client's money is not used to pay another during the course of a working day, thereby creating an intra-day shortfall. The impact of this would be to reduce the overall amount within the client money pool, resulting in reduced payments to clients in the event of insolvency.

There are a number of scenarios that could lead to an intra-day shortfall, including:

- A BACS file containing redemption payments debiting the client money bank account prior to the receipt of trustee/fund provider settlement.
- Fees and charges debiting the client money account but which are not payable by the clients
- Deals settled while awaiting cheque clearance

The FCA has stated that firms are required to 'minimise' the risk of an intra-day shortfall, and in doing so have provided options available to firms:

Prudent Segregation

This involves firms 'ring fencing' their own money within a client money account to help avoid an intra-day shortfall and this has been recognised by the FCA as accepted practise under rule 7.13.41R.

Prudent segregation could be used where firms, due to the complexity of their business, cannot easily determine the movement within the client money bank account during the course of a working day and therefore are unable to easily identify any intra-day shortfall that may occur. Control of complex client money bank accounts, often relying heavily on external parties such as banks and BACS, would be a 'resource-heavy' process requiring complete manual intervention and control, increasing risk of errors and ultimately breaches.

When determining the value of the amount that is to be segregated, firms must carry out a suitable review of all processes and transactions that affect the account to establish the risk of a shortfall occurring over a specified period of time (3 months would be the recommended minimum). A methodology for the calculation of the cash figure must then be agreed by the firm and documented within an internal policy detailing the risks that have been identified as a result of the review and why the value to be segregated is justified against those risks.

The firm's policy and approach to prudent segregation can be changed over time, provided the firm carries out a further suitable risk review to justify any change. Rationale for this change must be recorded within the firm's internal policy. Details of a firm's prudent segregation policy must be retained for 5 years after the money is withdrawn.



PS 14/9 Review of the client assets for investment business

For firms that use Third Party Administrators (TPA), the firm must take responsibility and ownership for the policy and agreed amount.

Any value that is placed in the firm's client money account under the prudent segregation rules must, under the rules covering client money reconciliations, be included in the client money requirement, and clearly identified within the books and records. As a result of this, any prudent segregation must also be included within the firm's CMAR return.

Should some or all of the prudent segregation value be removed from the client money bank account, this must be completed by removing this value as an excess within the firm's internal client money reconciliation as per 7.15.29R.

Firms should therefore, once their internal policy has been amended and agreed, remove the value of cash from the client money bank account and pass any internal record keeping entries on the same day.

Pre-Funding

While pre-funding is not specifically detailed within the CASS rules, it is a suggested method by the FCA that allows firms to mitigate intra-day risks.

This would involve a firm placing an amount of money into the client money account that is specific to a transaction i.e. the exact value is known. An example of this would be where a known BACS file relating to redemption payments, is debiting the client money account for a specific value prior to the Trustee settlement being received.

A firm could fund the exact value, in some cases the day before, ensuring the payment is successful and that the settlement is received from the external party, before removing the funding as soon as practicably possible.

This option must be considered carefully as it relies on very specific controls around the client money account and firms need to consider whether the complexity of the account in question is suitable to be able to maintain sufficient control of the necessary processes. Risks would include not placing the money in the account in time to cover the payment and not removing the funding element once the settlement value had been received, leading to co-mingling.

If a firm chooses to use this option, any money placed in the client money bank account must be reflected in the books and records accordingly and treated as client money.

Changing Organisational Arrangements

Firms could opt to re-arrange their processes to ensure that all money is received prior to the payment, however this would prove difficult when relying on external parties and could disadvantage the client and also be costly.



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3.4 Cheques

Payment by cheque is still a method regularly used by clients. As such there are strict guidelines around what is considered 'prompt' banking as per CASS 7.13.32R. Current dated cheques that cannot be banked on the day receipt must be recorded and held securely until the following working day when they must be banked or returned.

The FCA considers cheques to be paid in 'on acceptance' at the bank.

Paid in 'on acceptance' can be defined as successful delivery to and acceptance by or receipt by the account holding bank within the required timeline of 'no later than on the business day after [the firm] receives the money' as per CASS 7.13.32R. Cheques may, for example, be deposited to the account holding bank via a bank branch, a cheque clearing service provided by the account holding bank or by a third party e.g. courier, Royal Mail. Successful delivery and acceptance/receipt can be evidenced by proof of the delivery, for example, the acknowledgement from a courier of delivery of the cheques, or signed mail delivery confirmation from Royal Mail. The firm can be considered to have met the requirement even if there might be subsequent delays by the account holding bank with the processing of the cheque/s.

This could pose issues for firms who are not situated close to their bank branches. This might place pressure on firms to use overnight couriers which could prove costly. This could lead to unavoidable breaches where there is a delay by the courier company in delivering the cheque. Should the firm choose to post the cheques, there could be a delay in the bank receiving the post.

Firms should consider their processes carefully, including their contractual arrangements with clients. Prudent segregation may also be required to fund cheques that are not banked in a prompt manner.

Industry standard for sterling cheque clearance is as follows:

- Deposit Day + 2 working days – cheque is cleared for interest
- Deposit Day + 4 working days – cheque is cleared for withdrawal
- Deposit Day + 6 working days – cheque is cleared for fate and cannot bounce

Some banks will offer commercial propositions to enable their clients to withdraw funds prior to Deposit Day + 4 therefore firms may wish to check the commercial arrangements they have with their bank.

In order to ensure intra-day shortfall risks do not arise, money should therefore only be used once the cheque is cleared for use. Firms should, however, contact their bankers to ensure they understand clearly the service that is being provided.