

## Prudent Segregation Guidance

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### INTRODUCTION

Under CASS 7.13.43R firms are required to have a formal policy on prudent segregation, guidance on this has been provided within this document. The policy must detail the following:

- (1) The specific anticipated risks in relation to which it would be prudent for the firm to make such payments into a client bank account;
- (2) why the firm considers that the use of such a payment is a reasonable means of protecting client money against each of the risks set out in the policy; and
- (3) The method that the firm will use to calculate the amount required to address each risk set out in the policy.

### WHAT IS PRUDENT SEGREGATION

Prudent segregation is a means of mitigating the impact to clients of a deficit in the Client Money ('CM') account on the occurrence of a Primary Pooling event.

If a firm deems it prudent to do so, it may pay money of its own into a client bank account to cover specific risks to clients (examples below) and subsequently retain that money in the client bank account. As confirmed by 7.13.41 R, this money is then client money for the purposes of the client money and distribution rules.

### KEY PRINCIPLES:

- a) Firms are required to have suitable "organisational arrangements" to minimise the risk of a deficit in the client money account. These organisational arrangements should **first** consider how the risk of a deficit in the CM account can be **avoided** and then (but only then) mitigated.
- b) Prudent segregation achieves greater protection by permitting the firm to maintain a balance of the firm's money in the CM account provided this is performed in accordance with the rules. This requires, without limitation, the maintenance of a Prudent Segregation policy and adequate records. Prudent segregation is not a "buffer".
- c) In order to mitigate the risk of contamination of the trust the only money held in the CM bank account is that in respect of clients or, where Prudent Segregation is operated, firm's cash that is held under the firm's Prudent Segregation policy. If the firm pays their own cash into the CM bank account and immediately, appropriately and thereafter treats the cash as CM for a client in the CM bank account then by definition this cannot be Prudent Segregation.

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### KEY PRINCIPLES IN OPERATION

Where the risk identified is “routine” the firm should consider amending their operational cash flows and/or controls to avoid the risk. Furthermore it might be inappropriate for a Prudent Segregation policy to cover the potential loss from an undefined or ill-defined risk e.g. dealing errors are a regrettable fact of life but all firms should have the organisational arrangements to control this risk. However, Prudent Segregation can be an effective means of mitigating the impact to clients of a deficit in the CM account on a Primary Pooling event when a dealing loss has arisen but the firm is unable to immediately quantify the loss and/or determine the impacted client(s).

Ultimately it is a matter of interpretation, but as confirmed by 7.13.43R firms should document their approach and obtain approval from its governing body. It would also be beneficial to discuss the approach with its auditors.

Importantly, Prudent Segregation is not intended for situations where the firm is able to resolve an identified issue. Prudent Segregation relates to a recognised potential exposure to the client population (rather than known current exposure to specific clients), and so Prudent Segregation sums are by definition not allocated to individual clients.

A Firm may therefore consider Prudent Segregation an appropriate response in two broad situations, which this paper discusses:

1. In response to an actual error, where the firm has identified that an error has arisen but cannot at that time allocate client money to resolve the case. For example, a dealing error where the investigation yet performed has not confirmed the exact population of affected clients and/or the exact money due to each client.
2. In response to an identified and assessed set of risks (not the realisation of those risks) which the firm considers could materialise during normal business activity yet not be immediately visible to the firm i.e. where the firm wishes to protect its clients against potential loss were the firm to become insolvent and a specific error only comes to light after the insolvency.

The use of Prudent Segregation does not absolve a firm from the need to establish adequate organisational arrangements to minimise the risk of loss or diminution of client money.

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### **RECORD-KEEPING**

Should the firm choose to prudently segregate, under CASS 7.13.50 – CASS 7.13.53 a firm must create and keep up-to-date records so that the amount of money paid into client bank accounts under CASS 7.13.41 or withdrawn under CASS 7.13.49, and the reasons for such payment or withdrawal, can be easily ascertained (the prudent segregation record).

The prudent segregation record must detail:

- (1) The outcome of the firm's calculation of its prudent segregation;
- (2) The amounts paid into or withdrawn from a client money bank account pursuant to CASS 7.13.41R or CASS 7.13.49R;
- (3) Why each payment or withdrawal is made;
- (4) In respect of the firm's written policy required by CASS 7.13.43 the firm must record, either:
  - a) That the payment or withdrawal is made in accordance with that policy; or
  - b) That the policy will be created or amended to include the reasons for this payment or withdrawal.
- (5) That the money was paid by the firm in accordance with CASS 7.13.41 or withdrawn by the firm in accordance with CASS 7.13.49; and
- (6) The up-to-date total amount of client money held pursuant to CASS 7.13.41.

Payments and records made in accordance with CASS 7.13.51 should not be used as a substitute for a firm keeping accurate and timely records in accordance with CASS 7.15 and requirements under SYSC 4.1.1 and SYSC 6.1.1.

The prudent segregation record must be retained for five years after the firm ceases to retain money as client money pursuant to CASS 7.13.41.

### **RISK ASSESSMENT**

Under CASS 7.13.43R (1) the firm must identify specific anticipated risks where prudent segregation would be required. Risks will differ from business to business as they will depend on the operating structure, complexity of the client money accounts, size of the organisation and volumes of client money transactions.

The list of risks should include as many potential/ perceived risks that can be identified and firms should take into consideration breaches where shortfalls on the client money bank account have arisen. A few examples of risks are outlined in the table below. Note that this is a non-exhaustive list of the risk elements that a firm might consider against their control environment, to determine whether any related prudent segregation would be appropriate in their case. Remember also that the assessment indicated here relates to the potential for such a risk to have crystallised without the

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error being visible to the firm at the time. The table is not describing the actions or quantification of exposure once an individual error has been identified and is being resolved.

The firm's policy should make clear the types of Prudent Segregation that the firm intends to undertake and ensure that a full risk assessment is conducted. Such risks may include the following:-

<b>Risk Identified</b>
Daily client money calculation/intraday review: physical cash movement into client money bank account is not made / made incorrectly, as a result of either the firm's failure or the bank's failure.
Incorrect payment e.g. incorrect value / payee details / value date.
An order is contracted on behalf of the wrong client
System failure results in prolonged shortfall in the client money account or the firm is unable to complete the daily client money calculation.
Depository/ client failing to pay for liquidations/ purchases
Cheque / Direct Debit receipts failing to clear and are returned unpaid
Foreign exchange rates used are incorrect
The client money pool has a shortfall due to fraud or theft.
The firm fails to deposit a client money receipt into a client money bank account

### RISK ASSESSMENT CONCLUSIONS

Following the risk assessment, firms should conclude which risks, if any, cannot be mitigated through controls/ processes and determine how much of the firm's money would be required to cover these risks and arrange for that money to be held as prudent segregation.

In the event that a new risk is identified, which was not previously considered, firms will need to reassess the prudent segregation policy and amend it accordingly, with immediate effect (CASS 7.13.46G).

### OVERSIGHT AND GOVERNANCE

It is recommended that the policy is subject to regular review (at least annually). The policy must be approved by a firm's governing body or CASS Oversight Committee (if applicable), in line with 7.13.43 R.

### IMPORTANT INFORMATION

This document has been compiled for the use of TA Forum members only and is for guidance purposes. The best practice and guidance statements have been written from the view point of TA's and the administration activities that they perform for regulated firms.

Where any firms require further clarification of the rules, guidance should be sought from the FCA. It is the regulated firm's responsibility to comply with the client money rules and ensure that they receive all required information in order that they can perform adequate oversight regularly. Firms are responsible for ensuring they have the relevant permissions to undertake such activity as they may outsource to TA Forum members. It is assumed that firms will have all relevant CASS permissions. For any queries regarding this document, please contact [enquiries@thetaforum.co.uk](mailto:enquiries@thetaforum.co.uk)

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