

Transaction-funding & Prudent Segregation in trade settlement (Part 2)

1 Introduction

This paper (“Part 2”) assumes that the reader is familiar with the earlier paper (“Part 1”) of the same name.

The further analysis provided in this paper demonstrates that whilst Transaction Funding requires the firm to finance the trade settlement process, the nature of that financing is not always (but is sometimes) a loan. Regardless of whether a loan is provided or not, the receipt from Transaction Funding in the Client Money bank account is to be treated as Client Money at all times.

It is possible for the firm to provide a service to clients that would not require the firm to finance the trade settlement process. However such a service will necessitate the firm receiving cleared funds from or on behalf of clients for client buy trades, and will commonly involve settlement of client sell trades the day after the contractual settlement date of the underlying asset to ensure that cleared funds have been received from the market/fund side. This model is perfectly workable but is unlikely to be attractive to clients given the delays necessarily involved in waiting to confirm that cleared funds have in fact been received, and hence unattractive to firms operating in a competitive environment (particularly when a better client proposition could be provided by a firm established outside of the UK).

Most firms provide some contractual settlements¹. Some of the firms will be acting as agent in the trade, and others will be operating as a principal in the trade. Where a contractual settlement service is offered and the client does not have sufficient cash to settle their transactions the firm will be providing finance.

It is a pre-requisite of Transaction Funding that the receipt of Transaction Funding in the Client Money bank account is treated at all times as though it is the client’s cash i.e. in the event of the firm’s insolvency the cash would be treated as Client Money. If a firm is not comfortable in treating the receipt as client cash in the way described given its own particular business model, then that firm will be unable to use Transaction Funding and will need to make other arrangements to deal with potential shortfalls in the Client Money bank account.

¹ Some retail platforms will generally operate a cleared funds policy for client buy instructions but nevertheless seek to provide the ability to clients to switch holdings from a fund with a longer settlement period to one with a shorter settlement period e.g. from a T+4 fund to a T+1 fund. These firms will need to provide liquidity to the settlement process.

In this paper the nature of the financing provided to the trade settlement process is discussed with respect to a buy order and a sell order in each of the following business models.

1. Firm acting as an agent and providing a platform service via a nominee company, as described in section 2 of this paper.
2. Firm acting as an AFM and acting as a principal in the trade, as described in section 3 of this paper.

Clearly there are other types of firm and business models that are not directly considered in this paper. Furthermore firms may act as an agent or act as a principal in the trade in a different way to that described in sections 2 and 3 of the is paper, and may have arrangements other than Transaction Funding to avoid intra-day shortfalls in the Client Money account or to mitigate the impact of intra-day shortfalls that do arise.

The analysis in this paper is performed with respect to the business models described and the conclusions are relevant solely to those business models. Different conclusions are possible for other business models. It is important that firms do not look to apply the conclusions from this paper too generally to other business models without considering how those business models might affect the analysis and the conclusions.

2 Platform dealing as agent and using a nominee

For the purpose of this paper this business model is defined as follows:

- 2.1 Since the firm is acting as an agent the principals in the trade are the firm's client and market counterparty.
- 2.2 The firm aggregates the buy trades from their clients and executes an aggregated buy trade with the market counterparty. The resultant holding from the buy trade will be held (in accordance with CASS 6 and the relevant custody agreement) with a nominee company.
- 2.3 The firm aggregates the sell trades (separately to the buy trades) from their clients and executes an aggregated sell trade with the market counterparty.
- 2.4 The trade aggregation process does not change the principals to the deal performed. However, the trade aggregation process requires the firm to have a process to ensure that the aggregated trade(s) can settle and this is achieved (in the absence of a cleared funds only business model) via contractual settlement.
- 2.5 The nominee company is a mere passive repository of the relevant assets with nothing to do except obey the principal (the firm's client, whether acting directly or through an intermediary).

- 2.6 These arrangements are detailed in the firm's terms and conditions. The firm (through its terms and conditions) undertakes to hold the client's **Cash Balance** in accordance with the CASS rules.
- 2.7 For a client buy trade the firm's client will attain a beneficial interest in the asset from the trade date. The nominee will attain legal ownership of the asset once the trade has settled with the market counterparty.
- 2.8 For a client sell trade the firm's client will attain a beneficial interest in the proceeds of the trade (in exchange for its beneficial interest in the asset) from the trade date.
- 2.9 It is interesting to note that for a client *buy* it is not relevant to the client's beneficial interest in the asset whether they have paid the firm or not. However the payment by the firm's client for a buy trade to the firm will impact the client's **Cash Balance**. The client's **Cash Balance** held by the firm will change as a result of the receipt by the firm of the client's cash in respect of trade consideration of the buy trade.

3 **AFM dealing as Principal**

For the purpose of this paper this business model is defined as follows:

- 3.1 Since the firm is acting as a principal the principals in the trade are the firm and the firm's client.
- 3.2 The AFM does not provide a contractual settlement service to clients (but does to the funds).
- 3.3 The firm aggregates the client buy and sell trades either separately or together. The firm can also decide to adjust the firm's box holding. The firm will then execute a separate trade or trades with the fund.
- 3.4 For a client buy trade the firm's client will attain a beneficial interest in the asset from the trade date. The firm's client will attain legal ownership of the asset when the firm receives cleared funds from the firm's client on or after the contractual settlement date and at the same time as the firm receives cleared funds in the firm's bank account.
- 3.5 For a client sell trade the firm's client will attain a beneficial interest in the proceeds of the sell on the trade date.
- 3.6 These arrangements will be detailed in the firm's terms and conditions. The terms and conditions will also detail how the client's Cash Balance will be held by the firm. The firm's terms and conditions will include what part of the client's Cash Balance is to be held in a Client Money account e.g. some firms may use the 24hr window.

3.7 In this model it is interesting to note that the firm's client will not attain legal ownership of the asset without providing payment for the trade to the firm's bank account i.e. the firm's client does not have legal ownership of the asset when they have not paid or their payment is in the Client Money bank account. Furthermore for a client sell trade to an AFM the firm's client has always delivered the asset to the AFM firm on the trade date (in exchange at the same time for the beneficial interest in the cash proceeds of the trade).

4 The client's Cash Balance

4.1 CASS 7.16.22 provides a template methodology for the calculation of the **Client Balance** for each client. CASS 7.16.22 (3) (4) states that this methodology may be relied on as tending to establish compliance with CASS 7.16.21 R. As such CASS 7.16.22 provides a framework to look at the impact on the **Client Balance** when the firm is providing a contractual settlement service for their clients.

4.2 The sum of the positive **Client Balance** for each client represents the amount of cash that the firm should be holding in the Client Money bank account (CASS.7.16.20 and 7.16.21)

4.3 For a platform dealing as agent, and in accordance with CASS 7.16.22, the **Client Balance** will include

- For a client sell trade, the amount owed to the client from the point of the receipt of those funds to the settlement with the client
- For a client buy trade the amount received by the firm from the client until the time that those proceeds are passed to the counterparty.

4.4 For an AFM dealing as a principal, and in accordance with CASS 7.16.22, the **Client Balance** will be calculated in the same way i.e. the **Client Balance** calculated in accordance with CASS 7.16.22 is the same for the platform operating as agent and the AFM operating as a principal.

5 Contractual settlement with Transaction Funding

Transaction Funding requires the firm to treat (at all times) the receipt in to the Client Money account as Client Money. It is a necessary condition that the firm's internal records and reconciliations are consistent with this treatment and it is entirely reasonable for the firm to maintain a policy to this effect. It is also reasonable to expect that the firm's terms and conditions reflect the policies operated by the firm.

This section considers how the Transaction Funding provided can be achieved in compliance with the CASS rules.

5.1 For a client buy deal via a platform operating as an agent in the trade, as described in section 2, and providing Transaction funding:

- 5.1.1 The Transaction Funding provides a loan to the client. The loan commences at the point of receipt in to the Client Money bank account from a payment initiated by the firm. The loan is provided to the firm's client on the same day as the firm's client is obligated to make payment to the market counterparty. The receipt in the Client Money account is treated as a client receipt.
- 5.1.2 The cash in the Client Money bank account (from Transaction Funding) is used to settle the client's obligation to the market counterparty. The settlement with the market counterparty will happen on the same day as the firm provides the Transaction Funding.
- 5.1.3 Following the settlement with the market counterparty the effect of the Transaction Funding is that the firm's client has "swapped" the obligation to the market counterparty for an obligation of the same monetary value to the firm. Transaction Funding facilitated this "swap" of the firm's client's obligation and facilitated the client's settlement obligation to the market counterparty via the Client Money bank account.
- 5.1.4 For the purposes of determining the Client Balance the firm will need to consider whether the asset is "delivered" to their client for the purpose CASS 7.16.22. However this is the same consideration whether or not Transaction Funding was used i.e. if the firm settles the client's obligation from the firm's account or via the Client Money account with firm's cash held under a Prudent Segregation policy, the firm needs to determine whether the asset is "delivered" for the purpose of CASS 7.16.22.
- 5.1.5 The loan is repaid when the trade consideration is settled by the investor to the firm's Client Money account. Since the loan becomes repayable on receipt into the Client Money account, the money becomes due and payable to the firm and needs to be withdrawn promptly via CASS 7.11.34.
- 5.2 For a client buy deal via an AFM operating as a principal in the trade, as described in section 3, and providing Transaction funding:
 - 5.2.1 The Transaction Funding provides a loan to the client. The loan commences at the point of receipt in to the Client Money bank account from a payment initiated by the firm. The receipt is treated as a client receipt.
 - 5.2.2 The loan is extinguished at the point in time that the firm removes the cash from the Client Money bank account for payment to the market counterparty (i.e. the fund) or, where the firm has settled the obligation to the market counterparty (i.e. the fund), for payment to the firm. This will usually happen on the same day.

- 5.2.3 At the end of the loan period the firm's client has exactly the same obligation to the firm as they had prior to the provision of the loan i.e. the firm's client is required to pay the firm for the deal performed. The firm will not consider that the client has paid for the deal and will not consider the asset has been delivered to the client until actual payment has been made.
- 5.2.4 Transaction Funding in this scenario may be an incomplete solution to the problem facing the AFM of paying the full creation value to the trustee from the Client Money bank account. This will happen if the amount of the creation payment is greater than the sum of the investors transactions represented in the creation.
- 5.3 **For a client sell deal** via a platform operating as an agent in the trade, as described in section 2, and providing Transaction funding:
- 5.3.1 The Transaction Funding is provided by the firm to the Client Money bank account by exchanging the client's entitlement to the proceeds of the market counterparty trade with an obligation by the firm to make payment to the firm's client of the proceeds on the day that the Transaction Funding happens.
- 5.3.2 To the extent that these obligations are "swapped" there is no loan to the firm's client since the firm will have acquired the counterparty risk.
- 5.3.3 The actual receipt from the firm's counterparty (that in the circumstances mentioned above) would happen after the payment from the firm to the client will be removed from the Client Money bank account as a result of the application of CASS 7.11.34.
- 5.3.4 The obligations that have been swapped as a result of Transaction Funding would commonly both be payable on the same day as the obligation of the market counterparty. However for direct credit payments through BACS the firm's obligation should be paid to the client (via Transaction Funding) one day prior. The receipt (one day prior to the due date) would be reflected in the Client Money requirement.²
- 5.4 **For a client sell deal** via an AFM dealing as principal in the trade, as described in section 3, and providing Transaction funding:

² For direct credits payments through BACS the payment out occurs very early in the morning necessitating the advance to occur on the prior business day to avoid an intra-day shortfall on the payment day.

5.4.1 Any payment from the firm to the Client Money bank account on the contractual settlement date is performed in accordance with the AFMs obligation to the client (not as a result of Transaction Funding). The AFMs obligation to the client is not dependent on the AFM's receipts from an associated liquidation (though in the general course of trading the AFM may choose to meet the obligations to their clients (see PS14/9 7.46) only after the receipt of the associated liquidation). In practice, the only Transaction Funding performed by AFMs for a client's sell trade will be to provide payments to the client via BACS – see 5.3.4 above.

5.4.2 ***Transaction Funding*** can only happen in advance of the contractual settlement date. However, the Transaction Funding provided in respect of BACS is not a loan but an early payment of the obligation to the client and treated as such in Client Money requirement i.e. the amount in the Client Money account is the obligation to the firm's investor. The early payment by the firm permits the firm to make these payments by BACS from the Client Money bank account without using another client's money.

6 Conclusions

From the analysis performed, and in respect of the specific business models and scenarios considered:

- Transaction Funding of a client sell trade ***is not a loan***.
- Transaction Funding of a client buy trade does require a loan to a client.
- For a buy trade with a principal the duration of the loan is intra-day
- For a buy trade with an agent acting via a nominee the loan ceases when the client makes payment.

As stated in section 1 of this paper these conclusions are derived from the analysis performed with respect to the business model described. It is important that firms do not look to apply the conclusions from this paper too generally to other business models without considering how those business models might affect the analysis and the conclusions.