Transaction-funding & Prudent Segregation in trade settlement

1 Purpose

The paper describes the differences between Transaction-Funding and Prudent Segregation and how each can be operated by firms.

The operation of a Client Money account requires a firm to have the organisational arrangements in place to avoid using cash held in a Client Money account for one client for another client's transaction. Where a firm has identified a risk that cannot otherwise be avoided a firm is also required to consider mitigating the impact of a deficit that might arise on a primary pooling event.

The required organisational arrangements can impact on many aspects of a firm's operations and the design of their cash processing and control activities.

The purpose of this note is to describe the use of Transaction-Funding and Prudent Segregation as part of firm's organisational arrangements. Transaction Funding and Prudent Segregation are different and complimentary processes that should ***both*** be considered by firms in the design of the required organisational arrangements.

Prudent Segregation is a defined term in CASS. Transaction funding is not a defined term but is nevertheless performed in accordance with the CASS rules.

2 Introduction

Trade settlement commonly involves a series of related cash transactions e.g. when a client instructs the firm to sell an asset the firm will execute that trade in the market. The resultant settlement will involve a payment to the client from the firm and a related receipt by the firm from the market counterparty.

When the firm operates a Client Money bank account the firm is required to have organisational arrangements in place to minimise the risk of using one client's funds in the Client Money account for another client's transaction(s). This can only be achieved by ensuring that the receipt and clearance of the client's funds into the Client Money bank account happens before the payment out of those funds to the same client.

However firms are not in control of the timing of the receipt (except to the extent that it is expected at some time on the contractual settlement date) since this will depend on the timing of the release of funds from the market counterparty and the operation of the banking system. The firm may also be contractually obligated to make payment to their client on the contractual settlement date. Nevertheless the design of the firm's required organisational arrangements arising from CASS must accommodate the inability of the firm to control the timing of the receipt.

There are a number of ways that firms might address this issue. Three of the possible ways are described below.

1) Wait for the receipt to the Client Money bank account and clearance of funds before making payment from the Client Money bank account. However this might delay payment (to the client in the example above) to the next day and may also be inconsistent with the firm's obligations (and in some circumstances possibly risks incurring regulatory breaches e.g. COLL). Some firms may choose to amend their contractual terms but the arrangement is unlikely to appeal to the firm's clients (and therefore unlikely to appeal to the firm).

2) Make payment to the client from the firm's own resources (i.e. not from the Client Money account balance). Upon settlement of the receipt to the Client Money bank account the firm would transfer the relevant funds to the firm's account (since the firm has already extinguished the obligation to the client).

3) For the firm to identify the expected receipts to the Client Money account that are required to be received before any payment out of the Client Money account is made and make payment to the Client Money bank account from the firm's own resources the value of those receipts that have not been received prior to the release of the payments to the firm's clients.. The subsequent related receipt in to the Client Money bank account would then be transferred to the firm (again, since the firm has already extinguished the obligation to the client).

Both methods 2 & 3 above require the firm to make available their own resources to provide liquidity to permit settlement within the contractual time period. The requirement for liquidity is a feature of most if not all security settlement systems and a requirement for a timely settlement, which is clearly in the best interests of clients.

However the extent of the liquidity requirement can be very different between method 2 and method 3. Furthermore, method 3 requires a payment from the firm to the Client Money bank account and it is right and proper to consider the nature of that receipt in the Client Money bank account. Both the liquidity requirement and the nature of the receipt are considered below.

Method 3 is known in the industry as Transaction Funding. Whilst we prefer this term it can also be referred to as "Pre-Funding".

3 Transaction-Funding - the liquidity Requirement

A simple example demonstrates that the liquidity required from the firm would be greater for method 2 than for method 3.

E.g. a firm is expected to receive aggregated payments of £120 and £2000 in respect of a number of clients. When the firm is about to make the payments to their clients the firm has received the £2000 but not the £120.

- Method 2 requires the firm to make payments of £2120 from the firm's account before it is permitted by CASS to release the £2000 from the Client Money bank account to the firm's account. It is simply not feasible operationally to split the payments; one for £2,000 from the Client Money bank account and another of £120 from the firm's account.

- Method 3 requires the firm to make payment of £120 to the Client Money bank account prior to the release of £2120 from the Client Money bank account to their clients.

The example used above is a common situation faced by firms but does not normally arise due to either late or failed settlement. In the example the £120 would most likely be received on the contractual settlement date but too late on that day for the firm to wait for the receipt before releasing their own payments to clients prior to the banking cut-offs.

Unsurprisingly the smaller liquidity requirements from method 3 make this method the more attractive for firms. For some firms it might be the only practicable option available to them given the size of these transactions through the settlement accounts.

4 Transaction-Funding – the receipt to the Client Money account

Since method 3 involves a receipt in to the Client Money bank account from the firm it is right and proper to carefully consider the nature of the resultant cash in the Client Money bank account to avoid any pollution of the trust and to make certain the nature of the cash in the account in the event of the firm's insolvency.

It is a necessary condition for Transaction-Funding that the receipt in to the Client Money bank account is treated as Client Money at all times through the firm effectively lending cash to the specific clients temporarily. Transaction-Funding is performed for known clients and for known amounts for each client. This approach removes any possible confusion with Prudent Segregation. Prudent Segregation is the process where the firm can maintain **the firm's cash** in the Client Money bank account whereas a cash transfer performed as a result of Transaction-Funding is maintained in the Client Money bank account as part of the client balance i.e. **the monies belong to specific clients**.

This treatment (i.e. the amount of the Transaction-Funding is Client Money) permits the subsequent receipt from the counterparty to the client Money bank account to be released to the firm's account promptly since the firm has already met their fiduciary obligation to their client(s) i.e. the release to the firm's account from the Client Money bank account happens as a result of the application of CASS 7.11.34.

Transaction-Funding for any client usually persists for a short intra-day period. However it can persist longer in some circumstances e.g.

- Switches from a T+4 fund to a T+1 fund where the firm is required to settle the T+1 transaction (i.e. pay out) on T+1 but will not receive the related proceeds until T+4.

- Direct credit payments to clients where the payment out of the Client Money bank account happens very early in the morning and prior to any related receipt in to the Client Money account.

- The payment of a creation payment to the trustee from the Client Money account when some of the clients represented in the creation amount have not settled to the Client Money account prior to the firm/ CIS operator initiating payment to the trustee.

- A failed or recalled direct debit collection where the funds had already been allocated to investments. For example a £1m pension collection which failed and had been allocated by the system due to contractual obligations.

In the event of a firm's insolvency any Transaction-Funding payment made to the Client Money account will be treated as Client Money and in accordance with the Client Money Distribution rules. The firm when providing a contractual settlement service accepts the associated credit risk.

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 entirely reasonable for the firm to maintain a policy to this effect. Failure to provide transactional funding as soon as the firm is aware of the situation increases risk for the clients. Indeed, the absence of Transaction-Funding (whilst continuing to make payments out to clients from the Client Money bank account) would result in using one client's funds for another client's transaction (i.e. this is a certain outcome not a risk).

5 Prudent Segregation

5.1 INTRODUCTION

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 Client Money account can be avoided and then (but only then) mitigated.

Prudent segregation achieves a greater level protection by permitting the firm to maintain a balance of the firm’s money in the Client Money 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” and must be as a result of a calculation and not just an arbitrary amount. Prudent segregation is a means of mitigating the impact to clients of a deficit in the Client Money bank account that might arise on a Primary Pooling event.

In order to mitigate the risk of contamination of the trust the only money held in the Client Money bank account is that held in respect of clients and, where Prudent Segregation is operated, firm’s cash that is held under the firm’s Prudent Segregation policy. However, if the firm advances cash to a client and pays that cash into the Client Money bank account immediately, and appropriately and thereafter treats the cash as Client Money for that client in the Client Money bank account then by definition this cannot be Prudent Segregation.

A firm may identify that there are some risks of a deficit occurring in the Client Money account that it has not been able to avoid through the design of its operational processes. These are most likely caused by an event external to the firm and probably impossible for the firm to control e.g. a bounced cheque might create a deficit in the Client Money account but it will not be possible for the firm to identify (a priori) which cheque will bounce. Since it cannot identify (a priori) the cheque that will bounce it will not be able to identify the amount of the cheque nor the client that it is related to. In addition, the specific case may be totally outside the norm; e.g. normal bounced cheques could be an average of £5,000 but a specific case could be £100,000, which would not be covered by the prudent segregation amount. A firm is expected to have processes in place to identify that a deficit in the Client Money bank account has occurred and to promptly transfer the funds to resolve the deficit. This action is not affected by the operation of Prudent Segregation i.e. the deficit in the client money bank account that arose from the bounced cheque must be funded it is not funded from the amount held in Prudent Segregation since the amount in Prudent Segregation can only change as a result of the policy operated and following an internal reconciliation.

The purpose of the Prudent Segregation amount is to mitigate the impact of a deficit arising in the period from the deficit arising to the point in time that the shortfall is rectified. The shortfall is not remedied by the maintenance of a Prudent Segregation amount since the Prudent Segregation amount can only be increased or decreased in accordance with the policy operated and in accordance with rules provided in CASS. CASS 7.13.49 requires that any reduction in the amount of money held in respect of Prudent Segregation is withdrawn as part of the next reconciliation (not as an alternative to funding an identified shortfall).

6 Summary

	Prudent Segregation	Transaction Funding
Known clients	Probably not	Yes
Known amounts	Probably not	Yes
Held for a client	No	Yes
Held as firm’s cash	Yes. CASS 7.13.41R indicates this “is client money for the purposes of the client money rules and client money distribution rules.”	No
Specifically identified on the reconciliation?	Yes	No (held as part of the client balances)
When is cash transfer to CM made?	As per policy	As required
When is cash transfer out of CM made?	As per policy and at next reconciliation	CASS 7.11.34.
Specific rules?	Yes (in order to hold firms cash in the CM account)	No – not required