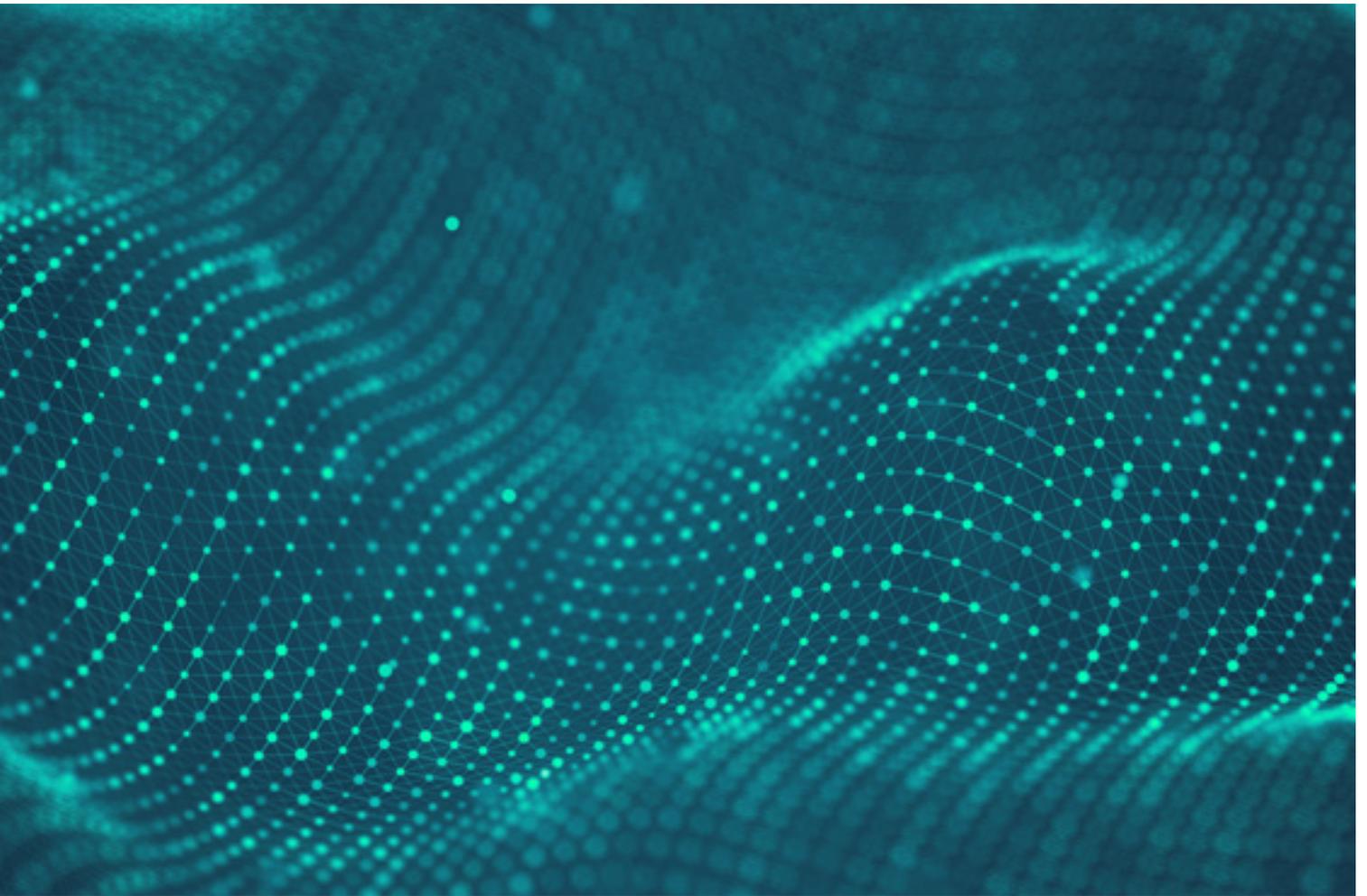


CASS 6.6.54 Stock Shortfalls

Identification and Treatment



AutoRek Overview

The AutoRek data management and reporting platform is capable of ingesting data feeds in a multitude of different formats and converting it into a user-friendly, easy to use format for reconciliation and reporting purposes. Typical forms include csv, excel, SWIFT and fund manager statements PDF statements.

Our scheduling functionality allows end-users to set the order in which they expect the business as usual events to unfold, prior to reconciliation completion. From the data feed consumption stage, to data validation, to matching and finally to labelling and investigation of exceptions, each stage of the process can be easily tracked and audited for any transaction or balance feeding the reconciliation.

The flexibility of the tool allows us to work with your existing data feeds rather than alter the expected delivery format, eliminating the need for change control requests with your third parties and/or custodians.

The integrity of the data will always be validated before being pushed to the final reconciliation. On standard external custody asset reconciliations, any internal and external aggregate asset balance movement will be automatically interrogated to attribute the movements back to the underlying transactions. This functionality can be extended to the internal custody asset reconciliation, giving the granular client level equivalent detail.

In our experience, working with our clients to understand their business processes and controls has significantly improved the STP matching rate, expedited exception resolution time, reduced FTE count and dramatically enhanced management information and reporting capabilities.

Introduction

Policy Statement 14/9 from the FCA introduced myriad of new CASS rules with far reaching consequences on FCA regulated UK firms. Perhaps the most stringent requirement was that of the 'Treatment of Shortfalls' in section CASS 6.6 effective from June 1st 2015. As with any new CASS rule, firms were obligated to be in a state of readiness as at enforcement date, therefore ensuring immediate compliance.

This new rule, coupled with the sizeable CASS 6 related fines for Barclays Bank Plc and BNYMLB/BNYMIL in 2014 and 2015 respectively, highlighted the FCA intentions to shift the focus from CASS 7 – Client Money more towards the CASS 6 – Custody Asset landscape. These two fines totalled in excess of £150 million and demonstrated the importance the FCA placed on the regime, which protected custody assets worth £10 trillion in the UK at the time.

✔ What are the Requirements Under CASS 6.6.54R?

As defined in the handbook:

“This rule applies where a firm identifies a discrepancy as a result of, or that reveals, a shortfall, which the firm has not yet resolved.”

If a firm determines it is responsible for the shortfall, it may appropriate a sufficient number of its own cash or assets to cover the value of the shortfall identified from the internal, external or physical asset reconciliation. The cash or assets must be held in a segregated client money or asset account to protect exposed clients in the event of insolvency.

A firm must then continuously re-value the shortfall using the previous day’s mark to market asset valuation. If the value of the shortfall has changed, firms need to perform the necessary adjustments to the original quantity of cash or assets set aside for protection.

Finally, a firm must keep a record of the shortfall description, underlying clients impacted, actions taken to resolve and the amount of money or assets the firm has segregated to protect impacted clients.

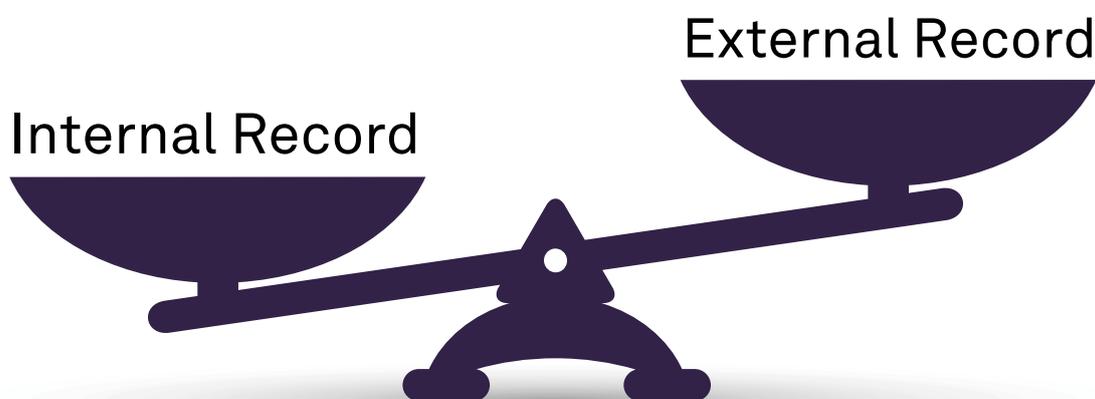
⚠ What’s the Significance?

Firms operating under the ‘Banking Exemption’ hold money from clients as Banker, and do not need to hold money from clients in accordance with the CASS 7 – Client Money rules. However, the introduction of CASS 6.6.54R has led to an increase in the number of firms granted a permission to hold client money on behalf of their clients.

Those operating within firms categorised as medium or large CASS firms will be familiar with the requirement to submit a monthly Client Money and Asset Return (CMAR) to the FCA. Section 8 requires firms to attest to their compliance around CASS 6.6.57R whereby the treatment of shortfalls is directly referenced within the rule book:

“A firm must notify the FCA in writing without delay if it will be unable, or materially fails, to take the steps outlined in CASS 6.6.54R for the treatment of shortfalls.”

Given that the CMAR acts as monthly insight into the performance and position of any UK medium or large regulated firm, this again re-enforces the emphasis the FCA places on the protection of custody assets.



Common Challenges

The fundamental cause of any shortfall can vary considerably, from failed market settlement to internal books and record errors, often making it difficult to immediately identify shortfalls. Many firms have taken the all-inclusive approach to shortfall protection, regardless of the party at fault. From an operational standpoint this approach may reduce the shortfall identification risk, but this puts a substantial drain on the liquidity of a firm's resources.

With mergers, acquisitions and third-party administrator outsourcing becoming increasingly common, many firms are facing the same dilemma regarding their IT systems and controls. Many systems were never designed to meet the CASS requirements. Efforts have been made to adjust functionality within existing system or build out inter-system connectivity to meet the ever-changing CASS landscape, but this comes at a significant cost to firms.

Ultimately, many financial firm's regulatory systems and controls are supported by Microsoft Excel documents and macros. This approach is not sustainable or scalable as any business grows; risk concerns around auditability, record retention, version control and ownership will always exist.

Downloading data manually exposes firms to unnecessary risk, as the process usually involves human involvement and a degree of decision making. Furthermore, obtaining the necessary data feeds to undertake a reconciliation can prove time-consuming, leaving little time to complete the reconciliation and most importantly fully understand the break causality.

Depots, accounts, designations, registration – all terms widely used in the custody asset reconciliation space. Without fully understanding the mapping and the relationship between these, the reconciliation and control process quickly becomes very convoluted.

The CASS rules dictate the external custody asset reconciliation must be undertaken at least monthly, but when assets are held electronically with a central securities depository, such as CREST, the reconciliation frequency should be set to daily. As good practice, there is an argument that reconciliations should be undertaken daily if the third-party data is readily available. In many cases the data is readily available, but the firm is lacking the resources to move to a daily reconciliation.

Any break in any reconciliation is a potential issue in the event of insolvency so firms must demonstrate they are allocating adequate time and resource to the root cause analysis.

Overcoming these Challenges – A Hypothetical Example

AutoRek have recognised these ongoing challenges for UK regulated firms and tailored the platform accordingly, particularly in the area of stock shortfall identification. The following hypothetical example outlines how the AutoRek platform has been developed in conjunction with the CASS rule requirements outlined in CASS 6.6.54R.

As noted earlier, CASS 6.6.54R stipulates a firm must appropriate its own assets or cash to protect their clients with shortfall exposure. However, the steps involved to establish when a true shortfall exists followed by the valuation of the shortfall often prove tricky for firms to maintain. A shortfall can arise from the internal, external or physical asset reconciliation. A counterparty party failing to deliver the stock on contractual settlement date often proves to be the most common cause of asset shortfalls.

This example assumes the firm:

- Performs a daily Central Securities Depository CREST external asset reconciliation on a settlement date basis;
- Offers contractual settlement to its clients i.e. on intended settlement date, the assets are added to a client's individual holding. A client buying assets has their cash account debited with transactional costs and the assets purchased added to their asset holdings.
- Receives a daily transactional and balance file from CREST via SWIFT message format MT535 and MT536.
- Segregates Client Money in a UK regulated financial institution. This Client Money is held in a Bank of Scotland GBP bank account and is specifically ring-fenced for those clients with asset shortfall exposure;
- Covers any asset shortfall regardless of the party at fault;
- Trades in multiple currencies - EUR, GBP and USD.

Settlement Date

Daily operational trading has commenced, and the secondary control of the daily external CREST reconciliation is underway. AutoRek has received the prior day's internal asset balance and transactional records as well as the prior day's CREST asset balance and transaction records. Following integrity checks, match rules and label rules, the following unmatched transactional records have flagged up as potential shortfalls requiring investigation:

| ISIN | Stock Name | Quantity | Currency | Counterparty |
|--------------|-----------------|----------|----------|--------------|
| JE00B4T3BW64 | Glencore Mining | 1,077.00 | GBP | Broker A |
| FR0000131104 | BNP SA ORD SHS | 966.00 | EUR | Broker B |
| US4592001014 | IBM STK USD | 1,000 | USD | Broker C |

AutoRek also consumes a daily pricing and FX rate data feed supplied by the firm. Using calculation and look up rules in AutoRek, prices and FX rates are automatically applied to each potential shortfall, providing an individual and overall Market Value (GBP):

| ISIN | Quantity | Currency | Price | FX Rate | Market Value (GBP) |
|--------------|----------|----------|--------|---------|--------------------|
| JE00B4T3BW64 | 1,077.00 | GBP | 309.45 | 1.0000 | £333,227.65 |
| FR0000131104 | 966.00 | EUR | 40.625 | 1.1469 | £34,217.28 |
| US4592001014 | 1,000 | USD | 163.14 | 1.3135 | £124,202.51 |
| | | | | | £491,647.44 |

These exceptions have now been stamped with a GBP market value to calculate the Client Money lock-up requirement. Posting rules are then used in AutoRek to push these shortfall labelled exceptions through to a dedicated stock shortfall reconciliation. Notes are applied to each shortfall to keep a record of the actions taken by the firm including a description, who the impacted clients are and the amount of money the firm has appropriated to cover the shortfall. These notes are held against the record indefinitely, stamped with the user ID and effective date.

AutoRek end-users use the platform to then initiate a transfer of £491,647.44 from a firm owned cash account to the pooled Client Money at Bank of Scotland. This real-world movement of funds must be replicated on the internal books and records of the firm. AutoRek auto-generates the cashbook journal required to mirror the physical movement of funds externally to the Bank of Scotland account.

Settlement Date

The reconciliation cycle repeats.

The CREST balance and transactional files are ingested by AutoRek, now showing successful settlement and therefore break clearance on two of the previously open items. The following exception remains on the reconciliation:

| ISIN | Stock Name | Quantity | Currency | Counterparty |
|--------------|-------------|----------|----------|--------------|
| US4592001014 | IBM STK USD | 1,000 | USD | Broker C |

New asset and FX rates are applied to the exception to establish the latest market value:

| ISIN | Quantity | Currency | Price | FX Rate | Market Value (GBP) |
|--------------|----------|----------|--------|---------|--------------------|
| US4592001014 | 1,000 | USD | 133.67 | 1.3089 | £102,123.92 |
| | | | | | £102,123.92 |

The remaining IBM exception is fed through to the dedicated shortfall reconciliation, which now shows an opening bank balance and cashbook balance of £491,647.44. The variance states a movement of cash £389,523.52 is required from the Bank of Scotland Client Money account to the firm owned cash account. The offsetting cashbook journal is also created by AutoRek to be fed back into the books and records system.

Workflow and Sign Off

Process workflows for the shortfalls model outlined above can be held within AutoRek and referred to by CASS Auditors, Quality Assurance or Internal Audit when undertaking control or substantive testing.

AutoRek can allow users to define a sign off tolerance based on volume of transactions or total GBP value, setting the appropriate sign off touch points required against any reconciliation.

Other ad-hoc BAU issues such as missing prices can also be catered for. The look up table would identify a case where ISIN price is null, or ISIN is not available and automatically label the transaction or balance with a missing price for investigation by data quality teams.

Auditability

Each data feed, transaction or balance is fully auditable and can always be traced back to the underlying source.

Each match rule, label rule or note is fully auditable and can always be traced back to the date of creation and user ID. Once a rule is live it can never be deleted, giving an indefinite record of the matching logic used at any point in time.

Real Time Dashboards and MI Reporting

AutoRek comes with a full suite of standard control and reconciliation reports for custody asset reconciliations. Configurable dashboards provide management with status updates of each reconciliation. The dashboards can be user specific, tailored to a group of users or available to everyone depending on the needs of the firm.

Standard custody asset dashboards include:

- Break volume per custodian;
- Break value per custodian (GBP);
- Assets held per custodian/fund manager;
- Asset type split per custodian;
- Break volume per department (internal);
- Break value per department (internal);
- Client count;
- Reconciliation completion status;
- Underlying break causes;
- Daily asset valuation chart;
- Asset prices, largest movers;
- Asset prices, missing prices;
- FX rate tracker on key currencies.

AutoRek is configured to always be on. These dashboard charts are real time and will update simultaneously with any manual or business rule initiated matching.

Conclusion

Ensuring compliance to CASS 6.6.54R continues to prove a significant challenge to FCA CASS regulated firms. For most firms, the constituent parts exist, but the disparate data feeds, operational BAU crossover and manual processing expose firms to unnecessary risk and more importantly, unnecessary risk to a firm's underlying clients.

Firms are now being challenged by the FCA and CASS auditors to illustrate how their business lines and legal entity structure maps to the CASS rulebook. This has proved to be a massive undertaking as it involves mapping CASS rules to risks to controls, a seemingly impossible task if data is not held in a single, central repository. This requirement will not go away. If anything, it is likely to become even more rigorous as the FCA tightens its grip on the Client Asset regime in the UK.

The AutoRek data management and reporting platform excels in the field of data consumption, retention and reporting, allowing firms to fully understand and make the most of their data from a reporting capability. By implementing a robust, automated financial control regime, firms will ensure ongoing compliance with Client Asset rules.

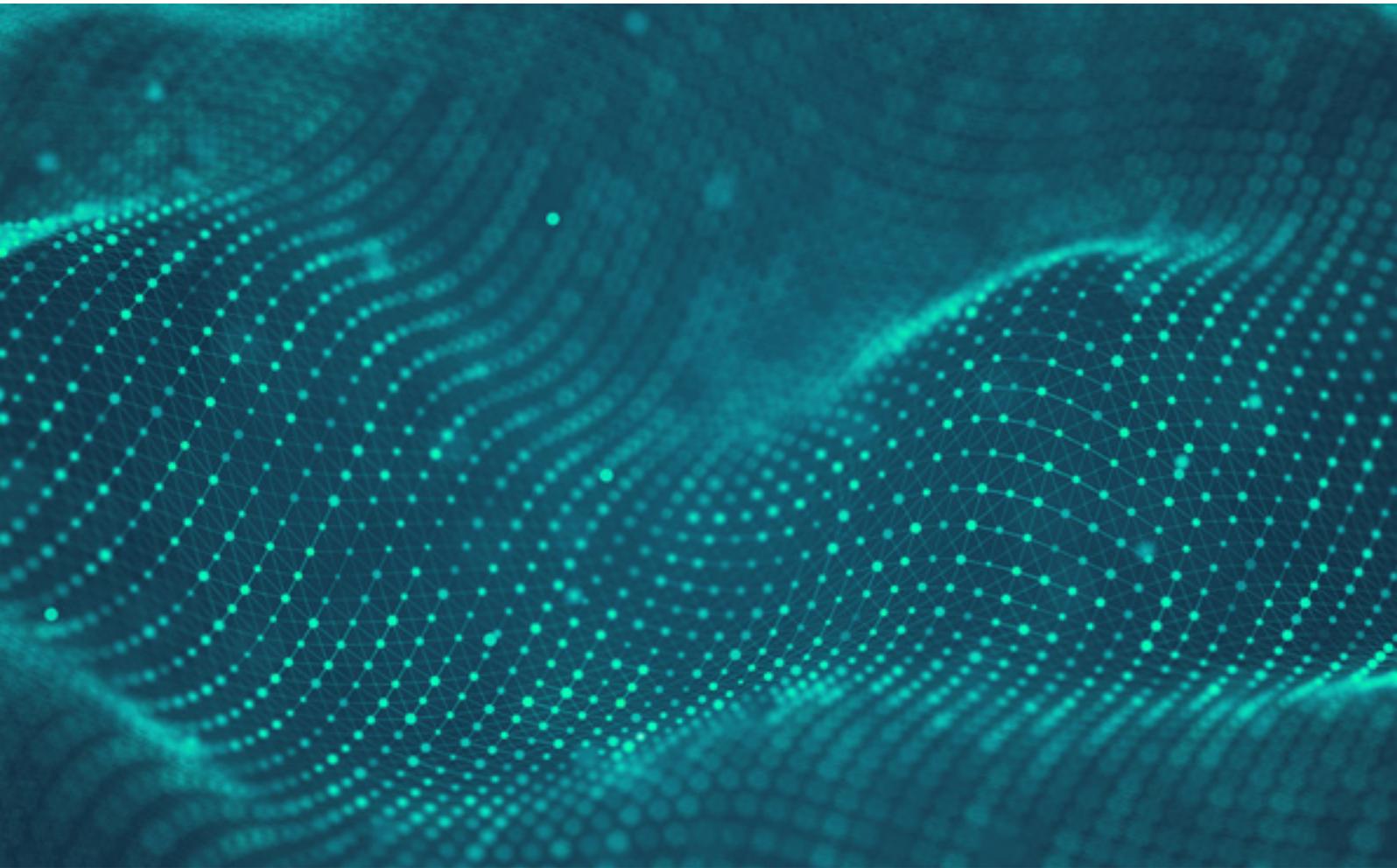
Arrange an AutoRek Demonstration

To arrange a demonstration or a confidential discussion to explore our methodology and credentials, please contact us:

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