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Financial Crime Compliance:

A Brief Guide for Senior Bank Management, Compliance Officers and Internal Auditors

Client Money: Don't Be in a Bad Place

Julian Sampson is a Compliance expert with a respected track record as both a financial regulator, Chairman of the Chartered Institute of Securities and Investment Compliance Forum and consultant. In this article for the GRU he tackles the challenges of separating FCA 'reality' from 'perception' by banks and regulated entities while confirming that the FCA latest rules are in fact meant to be taken seriously and on time – or else.

Don't Be in a Bad Place

If your firm has Financial Conduct Authority permission to hold client money or assets you should, by the time you read this, be well on the way to completing the changes to your procedures and documents in the light of the FCA's recent rule changes.

It's well to give this area close scrutiny. Client money continues to be a hot topic for the UK regulator, with a constant stream of fines handed out to firms for failures of process. As is usual with the FCA discipline, it doesn't have to be the case that someone's actually been caught with his or her hand in the till, or that the money has gone "missing". It's simply enough that your procedures were not sufficiently robust to prevent the possibility of such an event – or any other infraction – from happening.

And again with FCA discipline, there's little value in arguing with the FCA once they've made up their mind to that effect. You may think, with good reason, that your procedures are sufficiently robust and point to a blemish-free track record. But if the FCA disagrees with your analysis, you're in a bad place.

So it's good policy to pay close attention to the new rules in this area. Some of them have already passed their implementation date, but most come into effect by the end

of 2014 or mid 2015. And the most difficult to implement will be those which require the co-operation of parties outside your firm, and those which require a degree of lateral and green field thinking.

Here are some of the new rules which may be more than a simple challenge to overcome:

Letters

In the former camp come the new requirements for the letters to banks holding client money. These "acknowledgement of trust" letters are intended to confirm the beneficial ownership of the funds in the account and show their segregation from any other funds held in the bank.

Historically, this area has been rife with poor practice. When these letters did exist (and there have been significant cases where they did not) they had often been done poorly. The FCA pointed out in its Policy and Consultation papers issued in the run up to the new rules that often the most basic of execution formalities were not observed – letters were not dated, signed, or even when they were it was impossible to tell who had signed them.

On a more substantive basis, banks had inserted wording into the letters that undermined the letters' substance, and the FCA often found cases where firms were holding client money in accounts which were not covered by the provisions of the letter.

All should be much clearer now. The new rule, and associated guidance, gives firms a number of template letters to complete, with specified optional text to be deleted or retained as appropriate. The guidance specifies in some detail how the letters are to be executed, right down to the seemingly obvious points, such as this - don't do it in pencil. Thus many firms have made a start with their banks in agreeing these letters.

But beware. When dealing with large banking organisations – especially those headquartered overseas – there can be a time lag. There are a number of cases where the FCA's new rules and template letters have yet to filter down to the relevant level in their organisation where their staff face off to the regulated firm. As such, firms are still being presented by banks with old-style and soon-to-be-non-compliant letters. This can be immensely frustrating for the firm, but only goes to re-enforce the case that firms should be on the front foot with their banks as soon as possible.

Reconciliations

The new rules also embody a number of seemingly minor clarifications on process and procedure, for example, those on the central process of performing the client money reconciliation. These rules require firms to carry out some lateral and green field thinking. Firms are still free (largely) to choose the process that best fits their business but they must now define, for example, the frequency with which they carry out their reconciliations and their materiality threshold when dealing with differences. The FCA has stated that it expects firms to set out in their Client Money processes just how and why they do things the way they do.

For firms who have been used to a routine process over some years, this may induce a certain amount of head scratching. Just how often should client money be reconciled? What risk is posed by the volumes of transactions passing through the client money accounts? What is the link between the two? It's a reasonable assumption that in the absence of detailed metrics to guide the firm to an answer, the default position of reconciling on a daily basis will satisfy the FCA. However, for the smaller firm, this would be likely to impose significant administrative costs.

Material Breach

It's the same when considering materiality and the requirement to notify the FCA of a breach. Again, these requirements aren't new, but firms need to consider what they would regard as a material breach and when they would report that to the FCA. Early engagement with the firm's auditors will assist this process, given the auditor's own role in reporting to the FCA on whether the firm has or has not adhered to the rules.

Diversification

Similar thinking needs to be concluded in the matter of the choice of bank used to hold the client money. The requirement to consider both the soundness of the bank, and the need for diversification, are neither of them new. However both have been given added edge in the new rules. It may no longer be sufficient for firms to put their money with a major UK high street clearer on the grounds that they are who they are, thinking that if that bank fails then the FCA – and UK government – will cover the risk. This leads to a much wider problem than just client money.

So some rationale and documentation of thinking is required. It is likely that those high-street banks will still be the chosen client money bank for most UK investors. But this needs to be a considered process. It's also likely that most firms will only have a requirement for one client money bank, notwithstanding the FCA's comments on the advantages of diversification. For smaller firms, the administrative overhead of running parallel banking systems will not be in the client's best interests. The FCA has more or less acknowledged this, saying that it will be monitoring the diversification in those firms classified as "medium" and "large" client money firms – the implication being that smaller firms are not quite in this spotlight.

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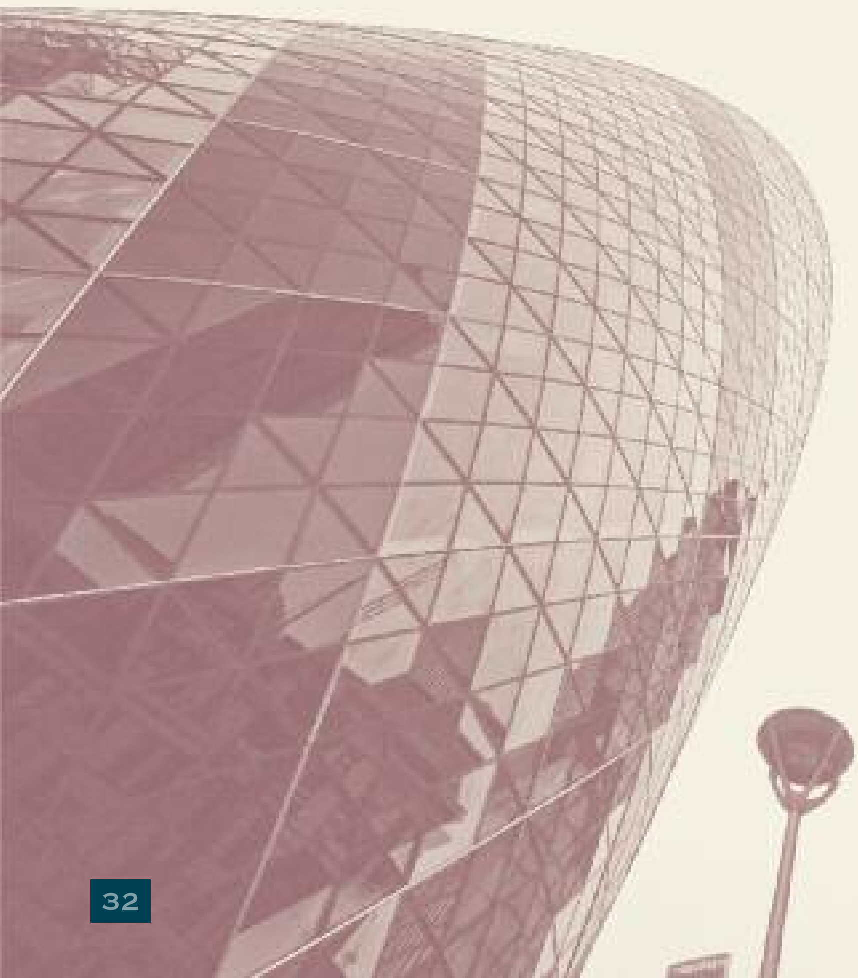
While no new rules have been issued by the FCA about the following it is good sense to ensure these areas are under scrutiny alongside compliance to the new rules:

Governance

Beyond the detail of the rule changes – and not specifically referred to by the FCA – firms need to consider the overall governance framework within which client money rests. Governance remains a critical area for the FCA across all areas of firm's activity, and they will want to know that the client money operations are adequately overseen by the firm.

All firms holding client money will already have either a senior member of staff holding the "Client Assets / Money Oversight" controlled function (CF10A) or a specified director responsible for this area. Their knowledge of the firm's processes and controls will be critical in convincing the FCA that this area receives adequate scrutiny.

But it can't end there. There's an extent to which the FCA will assume that this person knows their job - after all, if they're a CF10A they will have already been approved by the FCA. The FCA are just as likely to question fellow directors/non-executives on what they know about client money. For this to come off well for the firm there will need to be a regular routine of reporting from the CF10A or director responsible to the Board on client money matters, and not just once a year. The Board will be expected to know how the firm comes to hold client money, where it is held and some details of reconciliation processes. It's particularly important that the Board should be fully briefed on any process failure from late reconciliations to unexplained differences on the reconciliations themselves.



Training

All firms holding client money will have already recognised the need to ensure that their direct client money team are properly trained in the new rules. But consider casting the training net wider and giving all staff a general overview of the issues involved. Any FCA visit may involve interviews with staff from all levels of the organisation, most of whom will be remote from the day to day client money process. It's important that they know what to do if, for example, they open a letter which includes a client cheque. It would be unforgivable if they were allowed to think that they were acting within the scope of the firm's procedures by merely locking such receipts, however securely, in their desk drawer overnight.

And whilst you're looking at all of this, spare a moment to check on the Client Asset Resolution Pack. The rules in this area have not changed, but the FCA have recently carried out a review of Resolution Packs around a sample of firms. There's nothing inherently complex about the Pack – the information content should all be relatively attainable. The difficulty is making sure that it is up to date. Most firms will hold their Packs in electronic format, so take care to ensure that links to relevant folders / directories are all up to date and working properly.

Timetable

So what should firms be doing in the time still available to them before the implementation date? There is certainly still time to get everything in place – but that time should not be wasted. The first step should be to draw up a gap analysis setting out the changes required to be made to the firm's processes and policies. Once these have been identified, specific individuals / groups can be identified and tasked with drawing up the revised processes.

The culmination of this exercise should be the approval by the Board of the new processes and policies. This should certainly be at the macro level, in order for the Board to grasp the strategic issues of why the firm is holding cash or assets at all, and the control environment around them.

Once that process is complete, the firm can relax - but not for long. Central to the client money and assets regime is that the firm reviews its relationships and processes on at least an annual basis. The higher the volume of transactions or level of balances the more frequent such reviews should be. Such reviews will generally be conducted by or for the director responsible, CF10A, and will be reported to the Board. But there is a consolation: having put so much effort into the initial re-drafting of procedures and policies, such subsequent reviews should be a breeze!

Julian Sampson invites your questions via the GRU Editorial Team
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