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Financial Services Risk and Regulation

PwC paper: When is a custody asset held?

Navigating the 'Trade vs Settlement' debate

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Background

The custody rules in CASS 6 apply to a firm when it holds financial instruments belonging to a client. The record keeping and reconciliation rules in CASS 6.6 apply to the assets 'held' by the firm. The FCA has reiterated that a regulated firm needs to maintain its records and perform those reconciliations based on the assets actually held at a point in time.

This is commonly referred to as the 'settled' basis, and contrasts to the 'trade' basis where a firm additionally reflects the economic impact of any in-flight trades: e.g.: excluding assets which the client has contracted to sell; and including assets which have been purchased but not yet paid for. It is the firm's responsibility to determine the point in the trading cycle at which an asset becomes 'held'. For this purpose, cash settlement is often seen as a good indicator, but may not apply in all circumstances.

Where a firm's records or reconciliations do not correspond to the assets actually held (for example, external reconciliations are performed by comparing the trade basis position with a counterparty statement) the auditor is expected to report this as a breach over accuracy of books and records (CASS 6.6.3R) or external custody asset reconciliations (CASS 6.6.34R).

The purpose of this paper is to consider the various principles that should be considered, and applied, in the course of trading and settlement of equities and mutual funds, and whether each scenario results in client assets being held by the regulated firm. This is the basis of a generic PwC position which can then be applied to specific firm circumstances.

Principles that should be considered

When considering if assets are deemed to be ‘held’ (i.e. a client purchase trade has settled) a number of over-arching principles are required to be considered:

- Are the client’s rights reflected appropriately in the event of insolvency? Is the client protected from any loss?
- Does the client record show either the asset or the client money? In normal trading we would expect a client to have either an asset or money – but not both.
- Do the books and records accurately reflect actual movements of assets and money: i.e. is the asset ‘held’ in reality?
- Does the client consider the trade to be settled and consequently the firm’s obligation fulfilled?

Firms should also follow the principle of ‘best expectations’ – that is to say that a firm should maintain their books and records to the best of their knowledge and belief. That knowledge is not always perfect, and on occasion the expectation is not realised (e.g. a payment instruction to the bank is not processed). However, it’s better to record the transaction as having occurred (and be right 99% of the time) than to deliberately not record it until confirmation is received a day or more after the transaction actually occurred – and have books and records which you know are incomplete.

In this respect, most regulated firms will have trading processes and controls in place that result in completed transactions on the scheduled or contractual settlement date in the significant majority of trades. They should therefore rely on this control environment to ‘expect’ trades to settle as contracted. This allows them to update their books and records accurately on a timely basis, rather than requiring confirmation that trades have settled before updating their records. Waiting for confirmation of trades would mean that the records would be inaccurate for the days until the confirmation is received, breaching CASS 7.15.3R and CASS 6.6.3R. Furthermore, this could mean that regulated firms are using external information to update their internal books and records, which would breach CASS 6.6.14R and CASS 7.15.13R.

Specific exemptions are available to firms for treatment of client money.

- DvP exemption for Authorised Fund Managers: CASS 7.11.21R does not require firms to treat monies received as client money provided a) monies are for the purpose of the issue or redemption of units in an authorised investment fund and b) the firm delivers its obligation for delivery of units or redemption proceeds within 1 business day. Any monies received under the use of this exemption, do not need to be treated as client money in the scenarios and principled detailed further in this paper.
- Firm using the banking exemption: CASS 7.10.16R specifies money held by banks and other credit institutions is not considered as client money, and therefore does not require to be protected and segregated as such. Firms who are using the banking exemption therefore are not required to treat monies received as client money in the principles and scenarios detailed further in this paper.

Trading scenarios

When applying these principles, there are 3 distinct scenarios that firms can follow based on their trading arrangements with the market which drives the information that is available to them. The information available to firms ultimately drives the accuracy of their books and records:

Perfect information (Appendix 1): A firm is considered to have ‘perfect’ information when it has direct access to information over whether both client money and custody assets have been exchanged on the day the exchange occurs; and can update its books and records on this basis. Such firms may be a registrar or a direct member of a clearing exchange.

Near perfect information (Appendix 2): A firm that has ‘near perfect’ information has access the information of one side of the trade. For example, a firm that is a member of a commercial settlement system can see that for purchases, the client money has been exchanged. It can therefore use this information to conclude that the corresponding asset will be exchanged and update its books and records on this basis. This could include firms that use commercial settlement systems for trading.

Imperfect information (Appendix 3): When a firm has ‘imperfect information’, it does not have access to the above information on settlement date. This could include firms that trade through an intermediate broker or fund manager. A firm should therefore update its books and records according to the best expectation principle. The expectation made will depend on the nature of the trade, and any other available information; but in most cases the expectation will still be that the trade will have settled on the contractual date, and the books and records should reflect this.

Subsequently identified breaks, discrepancies, shortfalls and excesses should be followed up and resolved on a daily basis as normal, and would not cause the original treatment (booking of the trade) to be the incorrect thing to do, provided the firm’s best expectation was that the trade would settle.

Only if a firm’s best expectation is that the trade will not have settled should it not book the trade as settled on settlement date. Some of these scenarios are considered in this section.

This aligns with the industry use of updating books and records according to contractual settlement. Contractual settlement relies on firm’s having an adequate control environment to allow trading to settle on the agreed contract date, regardless of physical exchanges of monies or assets, and is therefore a firm’s best expectation of settlement.

Fund managers (Appendix 4): The scenarios above can be applied to trades in securities (shares) and funds (units). In the latter case the market counterparty will be the fund manager or Authorised Corporate Director (ACD). Where the investment firm is itself a fund manager or ACD, it will additionally have access to information on the creation/cancellation of units, and the ‘market settlement’ will be with the underlying Fund Trustee. Typically, the creation/cancellation of units takes place on ‘contract date’ which necessarily follows the trade date, but is still in advance of the cash settlement date. There are therefore three different stages which should be considered: prior to contract date, on contract date and on cash settlement date. For the purposes of illustration, it is presumed that cash settlement between the ACD and trustee always occur on cash settlement date.

Key terms and definitions are explained in Appendix 5

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Appendix 1: Perfect information

When a firm is a registrar or a direct member of an exchange, it directly creates and/or has access to the information indicating if an asset has been held or disposed of, including both the movement of the asset and the corresponding cash. This means that the custody asset record can be updated on an actual basis.

Asset purchase

Day	Asset received from market	Cash received from client	Cash paid to market counterparty	>	Custody asset held?	Client money held?	Notes
Before settlement date (1)	No	Yes	No		No	Yes	
		No	No		No	No	
On or after settlement date DvP	Yes	Yes	Yes		Yes	No	
		No	Yes		Yes	Negative	2
	No	Yes	No		No	Yes	3
		No	No		No	No	4
On or after settlement date – not DvP (5)	Yes	Yes	No		Yes	No	6
		No	No		Yes	Negative	7
	No	Yes	Yes		Yes/No?	No	8
		No	Yes		No	No	9

1. Prior to contractual settlement date it is presumed that no payment will be made by the firm to their market counterparty, and no asset will be received. The only remaining question is whether cash has been received from the client in advance of the purchase, in which case it will be held as client money.
2. Transaction pre-funded by the firm. Asset is held for the client with a corresponding client liability for the unpaid purchase cost. Client owes for the unpaid trade, which will be reflected in the individual client balance. If the overall client cash position is negative, this will be funded by the firm through the next day's internal reconciliation.
3. Client cash would be held under CASS 7 rules.
4. Trade will be rebooked or cancelled. There has been no cash movement between the client and the firm, and the firm and the market. No assets are held on behalf of the client.
5. When trading on a DvP basis through a commercial settlement system, purchased assets will be received when consideration is paid, or both legs of the trade will fail. In rare cases, or where trading with the market on a FoP basis, the cash and asset legs will not correspond, as shown here.
6. Firm has an outstanding obligation to settle with the counterparty, but the unpaid cash would not be segregated as client money.
7. Asset is held for the client with a corresponding client liability for the unpaid purchase cost. Client owes for the unpaid trade, which will be reflected in the individual client balance. If the overall client cash position is negative, this will be funded by the firm through the next day's internal reconciliation.
8. This is an example of where the principles conflict. The reality is that the firm did not receive the asset, and on that basis would not show it as 'held'; but the client has paid for it. That money has gone to the market counterparty, so it would not be appropriate to show it as client money held; which leaves the client with no entitlement to either money or asset. In these circumstances, firms should consider whether to record the client asset as held (to reflect the client entitlement) but then recognise a shortfall (to reflect reality). If the firm trades with the client on a contractual settlement basis, this strengthens the argument for recording a client asset entitlement and a shortfall.
9. Transaction pre-funded by the firm.

Asset sale

Day	Asset transferred to market counterparty	Cash paid to client	Cash received from market counterparty	>	Custody asset held?	Client money held?	Notes
Before settlement date (1)	No	Yes	No		Yes	Negative	2
		No	No		Yes	No	
On or after DvP settlement (3)	Yes	Yes	Yes		No	No	
		No	Yes		No	Yes	4
	No	Yes	No		No	No	5
		No	No		Yes	No	6

1. Prior to contractual settlement date it is presumed that no asset transfer will be made by the firm to their market counterparty, and no cash will be received. The only remaining question is whether cash has been paid to the client in advance of the sale.
2. Firm has prefunded the return of proceeds to the client. If paid from a client bank account this could be a CASS 7.11.34R breach.
3. When trading on a DvP basis through a commercial settlement system, consideration proceeds will be received when assets are transferred, or both legs of the trade will fail. In rare cases, or where trading with the market on a FoP basis, the cash and asset legs will not correspond. These cases are not illustrated, but the principles shown in the previous table can be applied.
4. Considered an Asset sale. Client cash proceeds held under CASS 7 rules until remitted.
5. Firm has pre-funded return of proceeds to clients. As the client has received the proceeds from sale, from the client's perspective this is considered settled. If paid from a client bank account this could be a CASS 7.11.34R breach. The asset should be recognised as a firm asset.
6. Trade will be rebooked or cancelled. There has been no cash movement between the client and the firm, or between the firm and the market. The original asset is still held on behalf of the client.

Appendix 2: Near perfect information

A firm with near perfect information is only able to see the cash side of the trade complete. However, under the ‘best expectations’ principle, if a firm can see that cash has moved on the contractual settlement date, and the trade is executed on a DvP basis; it can assume that the asset has also moved, and update its books and records accordingly. This effectively removes the anomalous situations, illustrated above, which can occur when cash and assets movements do not match.

Asset purchase

Day	Cash paid to market counterparty	Cash received from client	>	Custody asset held?	Client money held?	Notes
Before settlement date (1)	No	Yes		No	Yes	
		No		No	No	
COB on settlement date	Yes	Yes		Yes	Yes	
	Yes	No		Yes	Negative	2
	No	Yes		No	Yes	3
	No	No		No	No	4
Subsequent						5, 6

1. Prior to contractual settlement date it is presumed that no payment will be made by the firm to their market counterparty, and no asset will be received. The only remaining question is whether cash has been received from the client in advance of the purchase, in which case it will be held as client money.
2. Transaction pre-funded by the firm. Asset is held for the client with a corresponding client liability for the unpaid purchase cost. Client owes for the unpaid trade, which will be reflected in the individual client balance. If the overall client cash position is negative, this will be funded by the firm through the next day’s internal reconciliation.
3. Client cash would be held under CASS 7 rules.
4. Trade will be rebooked or cancelled. There has been no cash movement between the client and the firm, and the firm and the market. No assets are held on behalf of the client.
5. In the days following the contractual settlement date, further cash movements may occur, for example receipt of the purchase amount from the client. The books and records should be updated to reflect the new situation – in this example removing the negative cash position identified in note (2).
6. Additionally, confirmation may be received that the asset position is not as recorded. Where this is the late receipt of an asset from the market counterparty, the firm’s books and records can be updated to reflect the custody asset now held (and the cash corresponding settlement which has presumably been paid). However, if the confirmation shows that a custody asset which the firm has recorded as held, was not actually delivered; the firm will identify this as a discrepancy/shortfall and will need to follow the provisions in CASS 6.6.48G and subsequent rules.

Asset sale

Day	Cash received from market counterparty	Cash paid to client	>	Custody asset held?	Client money held?	Notes
Before settlement date (1)	No	Yes		Yes	Negative	2
		No		Yes	No	
COB on settlement date	Yes	Yes		No	No	
	Yes	No		No	Yes	4
	No	Yes		No	No	5
	No	No		Yes	No	6
Subsequent						7

1. Prior to contractual settlement date it is presumed that no asset transfer will be made by the firm to their market counterparty, and no cash will be received. The only remaining question is whether cash has been paid to the client in advance of the sale.
2. Firm has prefunded the return of proceeds to the client. If paid from a client bank account this could be a CASS 7.11.34R breach.
3. When trading on a DvP basis through a commercial settlement system, consideration proceeds will be received when assets are transferred, or both legs of the trade will fail. In rare cases, or where trading with the market on a FoP basis, the cash and asset legs will not correspond. These cases are not illustrated, but the principles shown in the previous table can be applied.
4. Considered an Asset sale. Client cash proceeds held under CASS 7 rules until remitted.
5. Firm has pre-funded return of proceeds to clients. As the client has received the proceeds from sale, from the client’s perspective this is considered settled. If paid from a client bank account this could be a CASS 7.11.34R breach. The asset should be recognised as a firm asset.
6. Trade will be rebooked or cancelled. There has been no cash movement between the client and the firm, or between the firm and the market. The original asset is still held on behalf of the client.
7. As with the purchase scenario above, the books and records will need to be updated to reflect any subsequent cash or asset movements, and any asset shortfall or discrepancy.

Appendix 3: Imperfect information

A firm with ‘imperfect’ information cannot see either side of the trade settling directly on settlement date. The extent of their information may be limited to just knowing that payment was made from the firm to an intermediate broker, but not whether the assets the payment was intended to fund were actually acquired. Such firms should still follow the best expectation principle – if under the control environment, a firm believes a trade has been successfully placed, it should update its books and records accordingly to reflect settlement. This will also align with updated books and records according to contractual settlement date, where a firm understands that a trade should process on contractual settlement date, and can therefore be considered as having settled by close of business on that date. As with the ‘near perfect’ scenario above, the books and records will need to be updated to reflect any subsequent cash or asset movements, and any asset shortfall or discrepancy.

However, if the nature of the trade is such that the firm does not have confidence that the asset movement has occurred; it does not have a basis for updating the custody books and records. Examples include ‘free of payment’ (‘FoP’) trades, and subscriptions to funds or share listings where payment has to be made in advance.

In situations where the firm has no information on the progress of a trade (such as a trade executed by an intermediate broker on an overseas exchange) then neither cash nor asset records would be updated until the trade is confirmed. However there are situations where the cash and asset movements are known to occur on different dates. If a client has subscribed to a speculative fund launch, and the firm has made a payment out of client funds, then it no longer holds client money (consistent with the CASS 7.11.34 R (2)(a) discharge of fiduciary duty). However it would be contrary to the principles of recording clients’ entitlement and protecting their interests in insolvency if the firm recorded no asset either. The client will have paid money and obtained no entitlement in return. In these circumstances, a firm should consider recording a ‘dummy’ asset representing the client’s entitlement to receive the shares/units when they are issued and/or return of their subscription payment.

Appendix 4: Fund managers

Fund purchase

Day	Cash paid to Trustee	Cash received from client	>	Custody asset held?	Client money held?	Notes
Before settlement date	No	No		No	No	1
		Yes		No	Yes	2
COB on contract date	No	No		No	No	3
		Yes		No	Yes	4
COB on settlement date	Yes	No		Yes	Negative	5
		Yes		Yes	No	6

1. Trade has not completed yet. No cash movements have occurred and no asset is being held.
2. Client has paid for the trade but no assets have been registered in the name of the client (or nominee) and there is no obligation on the firm to deliver the asset as contract date has not passed. Cash should be held as client money.
3. The trade is not considered to be settled. Although the units have been created due to arriving at contract date, market settlement (to the fund manager) has not taken place – the units are therefore cancellable at any time. As the units are still cancellable, they are not deemed to be held on behalf of the client.
4. If settlement date has not passed, there is no obligation for the delivery of assets which needs to be fulfilled. The fund trustee has therefore created the units without being paid for them. This is therefore not considered settled.
5. Units have been created and paid for by the firm to the fund. The lack of incoming client payment should be recognised as a negative client money entitlement, as the client is now a debtor of the firm (CASS 7.16.22E element F). The payment should be pre-funded by the firm. If paid from a client bank account this may be a breach of CASS 7.11.34R. Prefunding should be performed using corporate monies.
6. Trade has fully completed.

Fund sale

Day	Cash received from Trustee	Cash proceeds paid to client	>	Custody asset held?	Client money held?	Notes
Before settlement date	No	No		Yes	No	1
		Yes		No	Yes	2
COB on contract date	No	No		No	Yes	3
		Yes		No	No	4
COB on settlement date	Yes	No		No	Yes	5
		Yes		No	No	6

1. Trade has not completed (yet). No cash movements have occurred and the asset is still being held.
2. Although cash settlement date has not passed, the trade is considered settled as the firm has pre-funded the return of monies to the client. From a client’s perspective, as they have received the monies from the sale, the trade would be complete. If paid from a client bank account this could be a CASS 7.11.34R breach. The asset still exists and should now be recognised as a firm asset.
3. As contract date has passed, the firm is obligated to deliver. The client would expect that if the units have been cancelled, they would expect to have the cash therefore this would be considered as settled. The firm would be expected to prefund this into the client money account using its own monies. Should it pay this away from the client money account without prefunding, this would be a CASS 7 breach.
4. This trade is considered as settled as the client has received the proceeds. The firm would record a debtor from the fund, as the firm has pre-funded this redemption to meet the date agreed in the contract. If monies have been paid from the corporate account, this is not a breach. However, if the firm has paid this from the client money account, the firm must move firm money into the client money account.
5. Units have been cancelled. Therefore the client is entitled to the underlying proceeds. The firm should therefore move corporate money to the client money account to be held under the CASS 7 rules. Funds received prior to contract date cannot be held under the DvP exemption and must therefore be protected.
6. Trade has fully completed.

Appendix 5: Key terms and definitions

Trade date

Where a firm has placed a trade with a counterparty or fund manager, this transaction is considered to be 'traded'. For securities transaction, both the number of shares and the cash amount will be agreed as part of the trade. For fund transactions, only the number of units or value is agreed.

For this analysis we presume that a trade has been entered – so 'trade date' has passed. Any money received or held which is not connected to a trade would be considered free money and has no implications for holding custody assets. Any assets held which are not connected to a client trade would be considered firm assets and would not be covered by CASS 6.

Contract date

For fund transactions only: this is where the price per unit is calculated; and the resulting number of units, or cash amount to complete the trade is determined.

Settlement

Essentially there are three elements to settlement.

- Client cash settlement – client pays the cost of a purchase to the firm OR firm pays the proceeds of a sale to the client.
- Market cash settlement – For securities transactions and units in externally managed funds, firm pays the purchase cost to a market counterparty/receives the proceeds. For fund transactions where the firm is itself the fund manager/ACD, the firm pays the purchase cost to the fund/receives the proceeds.
- Asset registration – For securities transactions the shares are already in existence: settlement occurs when the security is re-registered in the name of the purchaser or purchaser's nominee company. For fund transactions, settlement occurs when the new units are created in the fund register, or cancelled in the case of a sale. Typically for fund transactions, this will occur on contract date.

  Note that for the purposes of maintaining its books and records, the firm may not immediately know that asset settlement has occurred. For this reason firms may update their assets records based on expected settlement or cash settlement.

Expected settlement date/contractual settlement

Analysis should take into account whether the agreed settlement date has passed, and whether the firm has agreed contractual settlement terms with the client. Prior to agreed settlement date, any money received or held would be considered free money and held in accordance with CASS 7.

If the firm has agreed contractual settlement, the trade should be presumed to have settled once the agreed settlement date has passed.

Products

Different scenarios apply to securities transactions and fund transactions

DvP through commercial settlement

Where securities or listed funds are traded through a commercial settlement system (e.g. CREST) on a DvP basis, market cash and asset settlement will occur on the same day (or not occur at all). This reduces the number of possible situations which can arise.

ACD type DVP

Where the firm is also the fund manager, any cash received or held in connection with fund transactions may be held in the firm's own bank account, rather than a client bank account. However this does not make a difference to the analysis of whether the corresponding asset is 'held' for CASS purposes.

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