

FSC Newsletter

Customer Money

Introduction

This newsletter outlines the processes that are required in relation to the accounting and controls required under legislation to be maintained by all firms regulated under the Financial Services Ordinances who hold customer monies.

When a customer entrusts funds to an authorised firm, regulations aim to protect these funds, to the maximum practicable extent, from claims of creditors of the licensed firm in the event of the firm's insolvency.

It is a requirement of the Financial Services (Accounting & Financial) Regulations 1991 ("the Regulations") for customer monies to be 'ring-fenced' from the other assets of the authorised firm. The regulations are also aimed at preventing authorised firms from using customer monies to finance their business. In effect, the regulatory requirements create a statutory trust under which an authorised firm must arrange for customer money to be adequately protected. This protection includes a requirement that customer money be kept separate from an authorised firm's money and for customer money to be fully accounted.

What is customer money?

The term 'customer money' is defined under Regulation 26 of the Regulations.

Customer money is:

"...money of any currency which, in the course of carrying on financial services business, a licensee holds or receives or which a licensee owes to a customer."

A licensee holds or receives money, as defined above, if:

"...it enters or expects to enter into an investment agreement with or for a customer and holds or receives in Gibraltar or elsewhere in respect of that agreement any money-

- a) which is not immediately due and payable on demand to the licensee for its own account; or*
- b) which although due and payable is held or received in respect of any obligation of the licensee which has not yet been performed."* (Regulation 26(2))

"Investment agreement" is defined under the Regulations as any agreement the making or performance of which by either party constitutes an activity which falls within any paragraph of Schedule 2 (Activities constituting Investment Business) or Schedule 3 (Controlled Activities) of Financial Services Ordinance 1989.

Customer money is therefore money held by the authorised firm for onward payment where the intended recipient is not the authorised firm.

The following are examples of customer money. These examples are not meant to represent an exhaustive list of what is or what is not considered customer money, but should serve merely as a guide. Customer money includes money held or received by the authorised firm:

- as agent, bailee, stakeholder, or as the donee of a power of attorney;
- for payment of unpaid professional disbursements;
- for payment of stamp duty, tax exempt fees, annual return fees, telegraphic transfer fees;
- as a payment on account of costs not of the authorised firm generally;
- insurance claim pay-outs;
- un-applied dividend or coupon payments.

It should be noted however that if the authorised firm has paid, for example, any of the disbursements mentioned above out of its own funds, or has provided the service on credit, payment subsequently received from the customer will be considered authorised firm money.

Accounting Records

Under Regulation 4 of the Regulations, authorised firms have a statutory duty, in respect of their financial services business, to keep accounting records which are sufficient to show and explain the firm's transactions. This obligation applies whether the authorised firm effects a transaction on its own behalf, or on behalf of others.

Accounting records should be such as to fully explain the financial position of each customer with respect to the authorised firm, accounting movements for those funds and the nature of the transactions concerned. A firm's accounting records should therefore contain, as a minimum:

- entries and explanations from day to day of all sums of money received and expended by the authorised firm;
- a record of all assets and liabilities of the firm including any commitments or contingent liabilities;
- entries from day to day of all purchases and sales of investments by the authorised firm distinguishing those made by the firm on behalf of others;
- entries from day to day of all money which is paid into or out of a customer bank account, including receipts and payments of customer money not passed through such a customer bank account, identifying the persons to whom such receipt or payment relates to; and
- a record of balances on individual customer bank accounts, balances on individual customer accounts at intermediate brokers and exchanges, balances with individual customers stating the name of each customer and the amount held or received for that customer and appropriate reconciliations.

Should the accounting records be insufficient to explain a transaction, then adequate supporting documentation to justify each movement must be maintained, and, if necessary, be appropriately cross-referenced to other records.

Authorised firms may choose to store vital accounting information on customer money in electronic form. A variety of software packages are used to facilitate this process. Where this applies, it is essential for authorised firms to ensure that this information is adequately backed-up and stored.

Reconciliation of customer money

Regulation 5 of the Regulations states that an authorised firm shall, at least every two months, reconcile the balance on each customer bank account (as recorded by the authorised firm) with the balance on that account (as set out on the statement issued by the bank). In addition to the above, if the customer bank account contains the money of more than one customer, then the reconciliation must clearly identify how much customer money stands to the credit of each customer.

The firm should also be able to demonstrate that an amount owed to a specific customer held within a pooled account can be reconciled with a record showing that individual's customer balance and is clearly identifiable at any time. In this context clearly identifiable means that by looking at the reconciliation, both the nature and amount of the funds deposited in the account are unambiguously stated and that a similar reference is contained in the customer's file. In other words, the authorised firm must maintain proper accounting records to show accurately the position of all money held for each customer.

The reconciliation of customer money should therefore include the balance as per the bank statements on the customer bank account, amounts received per cash book, amounts paid per cash book, and any un-cleared items. Funds held should, where applicable, be divided into genre such as, annual return fees, tax exempt fees, or general customer funds held. An example of a customer account reconciliation has been included under Appendix 1.

The authorised firm must also retain for at least six years, from the date of the last entry, all documents and records necessary to perform an adequate reconciliation, together with a record of the reconciliation itself.

Segregation

Authorised firms have a duty to segregate customer money from authorised firm money (Regulation 27). As mentioned earlier, the need to segregate is compounded by the statutory duty authorised firms have to keep customer money safe and to hold these funds on trust for customers. The fundamental principle behind segregation is 'ring-fencing'. Customer monies must be ring-fenced from an authorised firm's money for various reasons. These include:

- In the event that an authorised firm becomes insolvent, there is no question that customer monies will form part of the general assets of the authorised firm available for distribution.
- Customer protection is enhanced, thereby increasing confidence in the finance centre and authorised firms generally. It should be noted that some licence classes do not enjoy the benefit of an investor protection scheme or similar.
- The use of a customer's money must be for that customer's affairs only.
- The prevention of authorised firms financing their own operations with customer money.

The issue of segregation also becomes important when preparing annual financial statements. If customer and authorised firm monies are mixed in the same bank account, without an adequate reconciliation being performed on the said account, it becomes virtually impossible to differentiate authorised firm funds from customer monies for the purposes of reporting 'Cash at bank' on the balance sheet.

Customer Bank accounts

The Regulations require that an authorised firm which receives or holds customer money must open one or more customer bank accounts, separate from other accounts of the firm, with an approved bank. It is imperative for customer accounts, also known as “client accounts” or “pooled accounts”, to be designated as such in order to ‘ring-fence’ customer monies from potential claims against the authorised firm. The authorised firm must also give written notice to the approved bank informing it of the nature of the account and requiring that the bank acknowledge to the firm in writing that:

- All monies standing to the credit of the customer bank account are held by the authorised firm in trust and that the bank is not entitled to combine the account with any other account or to exercise any right of set-off or counterclaim against money in that account, in respect of any debt owed to it by the authorised firm.
- Interest payable to the account will be credited to the account.

In the event that the bank does not provide the acknowledgement referred to above, regulation 31(3) states that, within 10 business days of the dispatch of the notice by the authorised firm, the authorised firm shall withdraw all the money standing to the credit of the account, close that account and deposit the money in a customer bank account with another approved bank.

The authorised firm must also maintain full control of all bank accounts opened for the purpose of holding customer money. In order to ensure consistency with the four eyes principle, the Commission expects authorised firms to have dual signatory control on customer bank accounts.

Only a nominal sum will be required to open or maintain a customer bank account. In practice banks will usually open, and if instructed, keep open, accounts with nil balances, although some charges will usually be levied. In the event that a nominal balance is required, this balance must be clearly shown in the reconciliation schedule as funds placed by the authorised firm to facilitate operation of the customer bank account.

Except in so far as may be agreed in writing to the contrary between an authorised firm and each of its customers, the authorised firm shall, at least once every six months, credit interest to each customer on money held for that customer and standing (or which should be standing) to the customer’s credit in the customer bank account. The minimum rate of interest payable is the minimum deposit rate publicly offered by the approved bank at which the account is held. Interest provisions are of course dispensed with if the customer bank account does not earn any interest. It is therefore essential for such arrangements to be explained clearly within the customer agreement or other document establishing the basis of the relationship between the authorised firm and the customer.

Payments into & out of a customer bank account

Authorised firms have a statutory duty to account for customer money properly and promptly (regulation 30). In normal circumstances ‘promptly’ refers to banking funds either on the day of receipt or on the next working day. ‘Properly’ relates to producing and maintaining documentation necessary to explain the transaction.

Save as referred to in paragraph 33 of Part 5 of the Regulations, no monies other than customer monies should be paid into a customer bank account.

In the event that there are mixed funds in a payment to an authorised firm then the procedure should be for the entire sum to be paid into the 'customer bank account', regardless of its composition, and then to transfer any authorised firm funds or other non-customer money out of the customer bank account. This would be the case for example if a payment includes fees in respect of services provided by a firm or disbursements such as tax-exempt fees and Companies House fees. This transaction should again be done 'promptly and properly'.

The following may be withdrawn from a customer bank account, provided that the sums withdrawn do not exceed the total of the monies held for the customer concerned:

- (a) monies properly required for a payment to or on behalf of the customer;
- (b) monies properly required for or towards payment of fees or commissions payable to the authorised firm by the customer in accordance with the terms of the customer agreement;
- (c) monies properly required for or towards payment of a debt due to the authorised firm from the customer, otherwise than in respect of fees or commissions earned by the authorised firm;
- (d) monies drawn on a customer's authority or in conformity with any contract between the authorised firm and the customer;
- (e) monies which are not customer monies (i.e. in respect of mixed payments);
- (f) monies which are properly transferred to another customer bank account or into a bank account of the customer's choice.

In respect of (b), (c) and (d) above, authorised firms need to give customers 7 days notice of their intention, together with adequate detail of the breakdown of the proposed payment, and obtain a statement from the customer agreeing to the transaction. In addition, such withdrawals need to be duly authorised by a director of the authorised firm, or other person granted executive powers.

Auditors

In view of the above it is vital for auditors of authorised firms to ensure that firms have in place adequate procedures, records and systems in order to comply with, or to demonstrate compliance with, the requirements of the relevant Regulations. The auditor's report to the Commission, under regulations 20 and 40 of the Regulations, thus forms an integral part of the regulatory regime and provides a high level assurance that customer assets are safeguarded, risks are properly monitored, and that transactions are executed and recorded in accordance with established procedures.

When reporting to the Commission, auditors, together with the directors of the authorised firm, need to refer to the detailed requirements contained in the various Regulations and Newsletters before discharging their respective duties. The regulations provide very specific requirements in this regard. Further guidance is also provided to auditors under Newsletter 4/1992, and in respect of firms authorised under the Financial Services Ordinance 1998, in Administrative Notice Number 1.

Risk Assessment visits

As part of the Commission's risk assessment programme, inspection teams will pay very close attention to the manner in which authorised firms handle customer money. It is therefore crucial that authorised firms, and their respective auditors, ensure that the requirements of Financial Services (Accounting & Financial) Regulations 1991, particularly regulations 4, 5 and 6 and Part 5, Newsletter 4/1992, and Administrative Notice Number 1 are adhered to.

The on-site visits will seek to establish the adequacy of procedures for:

- the identification of customer money;
- assessment of client bank accounts and intermediate brokers;
- bank and broker acknowledgement;
- segregation of funds;
- the payment of monies in and out of customer money accounts;
- allocation of interest; and
- reconciliation of customer monies.

Appendix 1: Example of a Customer Bank Account Reconciliation

BALANCE AS PER BANK STATEMENTS 31/05/2005			<u>4,000.00</u>
	Chq No.		
LESS UN-PRESENTED CHEQUES:	101	100.00	
	103	<u>250.00</u>	
		<u>350.00</u>	
ADD NON-CREDITED ITEMS:	Description	50.00	
		<u>1,000.00</u>	
		<u>1,050.00</u>	
ADJUSTED CLIENT MONEY BALANCE			<u><u>4,700.00</u></u>
BANK BALANCE BROUGHT FORWARD		3,500.00	
RECEIVED PER CASH BOOK		<u>1,480.00</u>	
PAID PER CASH BOOK			<u>280.00</u>
BALANCE PER RECONCILIATION ABOVE			<u>4,700.00</u>
		<u>4,980.00</u>	<u><u>4,980.00</u></u>

RECONCILIATION SUMMARY	31.05.05
CLIENT FUNDS HELD	4,445.00
ANNUAL RETURN FEES HELD	30.00
TAX EXEMPT FEES HELD	<u>225.00</u>
ADJUSTED CLIENT MONEY BALANCE	<u>4,700.00</u>

CLIENTS FUNDS HELD	31.05.02
Client 1	1,300.00
Client 2	1,180.00
Client 3	<u>1,965.00</u>
	<u>4,445.00</u>
ANNUAL RETURN FEES HELD	31.05.02
Client 1	
Client 2	
Client 3	
Client 4	<u>30.00</u>
	<u>30.00</u>
TAX EXEMPT FEES HELD	31.05.02
Client 1	
Client 2	
Client 3	
Client 4	<u>225.00</u>
	<u>225.00</u>