CASS Audits 2024

An overview of all you need to know for auditors and firms planning for their CASS audits as well as for practitioners preparing their clients

Did you know?

From 1 November 2023, ICAEW's revised Continuing Professional Development (CPD) Regulations brought in new CPD requirements, including a minimum number of hours and an ethics requirement.

This webinar could contribute to up to 1 hour of verifiable CPD, so long as you can demonstrate that the content is relevant to your role.

Find out more about how these changes affect you at icaew.com/cpdchanges.

Agenda

	Topic	Presenter
1	Regulatory landscape and CASS	Jim Feasby, FCA
2	Getting the scoping right	Mduduzi Mswabuki, EY
3	Testing approach	James Edwards, Deloitte
4	Topical areas	Edward Westrip, Mazars
5	Quality control & reporting	Shermeen Kazmi, GT
6	Q&A	

Speakers

Jim Feasby, FCA

Mduduzi Mswabuki, Partner, EY

James Edwards, Senior Manager, Deloitte

Edward Westrip, Director, Mazars

Shermeen Kazmi, Partner, Grant Thornton

Regulatory landscape and CASS

Jim Feasby, FCA

Agenda

- Introduction
- Strategy update
- FCA's approach to CASS
- Audit quality
- Other audit related topics

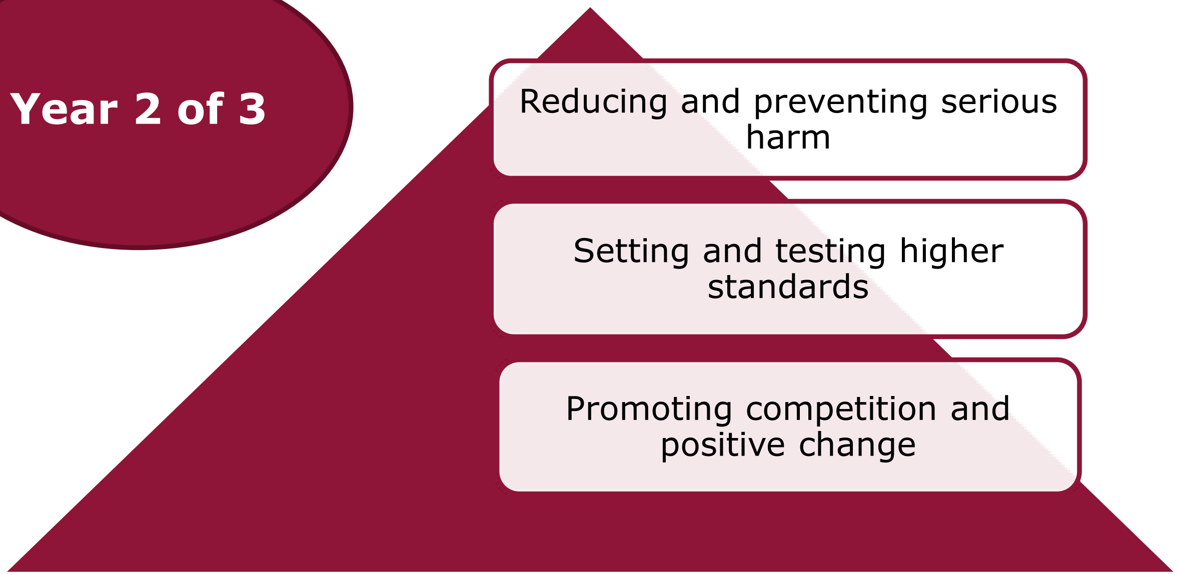
Introduction

CASS Regime

- Number of firms – c3,500
- Client money held – c£195.5 billion
- Custody assets held – c£16.4 trillion

Strategy

Year 2 of 3



FCA's approach to CASS

Supervisory approach

- c3,200 CASS Audit reports
- All reports reviewed and triaged
- Action decided by FCA based on information received in audit reports

Policy Approach

- Policy changes
- Strategic Initiatives
- DP 23/4 on Crypto assets (Stable-coins)

Audit Quality

Audit quality related issues

- Poorly drafted reports
- Lack of breach details in audit reports
- Undetected issues
- Use of third party audit programs without knowledge

FCA’s approach to dealing with poor quality

- Referral to audit supervisory bodies/FRC
- Use of FCA’s disciplinary powers under FSMA

Other audit related topics

- Interpreting the term ‘promptly’ in the context of CASS rules
- Threshold for CASS 5 audit exemption
- Late audit notifications

Getting the Scoping Right

Mduduzi Mswabuki, EY

Getting the Scoping Right

Ethical and independence considerations

FRC CASS Assurance Standard (Par 22 – 24)

Subject	Requirements
Ethical requirements	• The CASS auditor shall comply with relevant ethical requirements, including those pertaining to independence. • CASS auditors in the UK are subject to ethical requirements from two sources: the FRC Ethical Standard concerning the integrity, objectivity and independence of the auditor, and the ethical pronouncements established by the CASS auditor's relevant professional body.

Engagement acceptance and continuance	• The CASS auditor shall accept or continue a Client Asset Engagement only when the CASS auditor:
	    • Has reason to believe that all relevant ethical requirements, including independence, will be satisfied
	    • The CASS auditor is satisfied that those who are to perform the engagement, including the CASS engagement leader, have had appropriate training and will have the appropriate competence and capabilities; and
	    • The basis upon which the engagement is to be performed has been agreed between the CASS auditor and the firm, including the CASS auditor's reporting responsibilities to the FCA and also the reporting (as set out in paragraph 135) of the most significant matters requiring attention, in the auditor's professional judgment, to those charged with governance

CASS Scoping

CASS Scoping is the first thing we need to perform at the beginning of an engagement:

One of the most challenging aspects of the CASS scoping stage is determining whether a regulated firm is within the scope of CASS audit and then if it is, what type of report is required to be issued.

For all firms that are regulated by the FCA, the audit teams are required to document their considerations and conclusions in respect of whether a firm is within the scope of CASS audit.

Since the considerations and the level of work involved to determine whether a firm is within the scope of CASS audit will be different depending on the relevant facts and circumstances for each firm, audit teams will need to exercise their professional judgement in determining the amount of work required to validate their considerations and conclusions. Audit teams should not be relying solely on management representation to determine the scope of CASS audit, although this should be one of the procedures performed.

CASS 6 – Exemptions

CASS 6 Custody rules applies to a firm when

- It holds financial instruments for a client under MiFID business
- It is safeguarding and administering investments under its non-MiFID business
- It is acting as a trustee/depositary of AIFs or UCITs
- client transfers title of assets to the firm to cover obligations under specific products
- It is a small AIFM carrying on excluded custody activities

Exemptions

- Delivery-versus-payment (DVP) transactions (subject to limitations)
- Temporary handling (no longer than one business day)
- Trustees and depositaries (partial exemption)
- Arrangers (partial exemption)
- When clients have signed Title Transfer Collateral Agreements, the collateral rules (CASS 3) apply
- AIF/UCITS Managers in relation to excluded custody activities
- Firm carries on business in its own name but on behalf of the client, as required by the nature of transaction e.g. borrows custody asset as principal under stock lending agreement
- Safeguarding and administering (i.e. non-MIFID) for affiliates, unless affiliate is a client dealt under arm's length, or the firm has been notified that the custody assets belongs to affiliate's clients)

MiFID investment firms are:
1) Investment firms with the home office in the EEA/UK
2) Credit institutions that have registered office or home office in the EEA/UK

CASS 7 - Exemptions and Opt-out

CASS 7 Client money rules apply to a firm that receives money from or holds money for, or on behalf of, a client in the course of, or in connection with:

- **MiFID business**
- **Designated investment business**
- - **Stocks and shares ISA business**
  - **Innovative finance ISA business**
  - **lifetime ISA business**

Exemptions and Opt-out

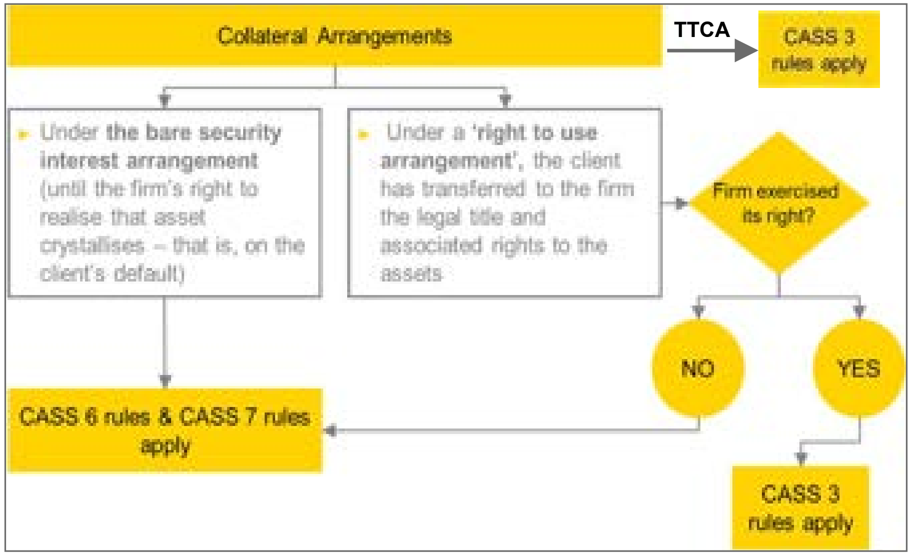
If the client's money is:

- Held under the 'banking exemption (i.e. by an approved bank in an account with itself)
- Due and payable to the firm
- Received in respect of a Delivery-versus-payment (DVP transaction)
- Professional clients opted out of client money protection
- When clients have signed Title Transfer Collateral Agreements, the collateral rules (CASS 3) apply

CASS 6 and 7 - Title Transfer Collateral Arrangement (TTCA)

Definition and application

- A Title Transfer Collateral Arrangement (TTCA) is an arrangement where a client transfers full ownership of client assets to a firm, and the assets are no longer regarded as client money or custody assets.
- Two types of arrangements:
  1. Bare security interest
  2. Right to use



Agreements

- Examples of the arrangements covered by this chapter include the taking of collateral by a firm, under the ISDA English Law (transfer of title) and the New York Law Credit Support Annexes (assuming the right to rehypothecate has not been disapplied).
- Re-hypothecation of collateral occurs where a firm exercises its right to take ownership of and use collateral received from its clients for its own purposes.

CASS 7 - Banking exemption

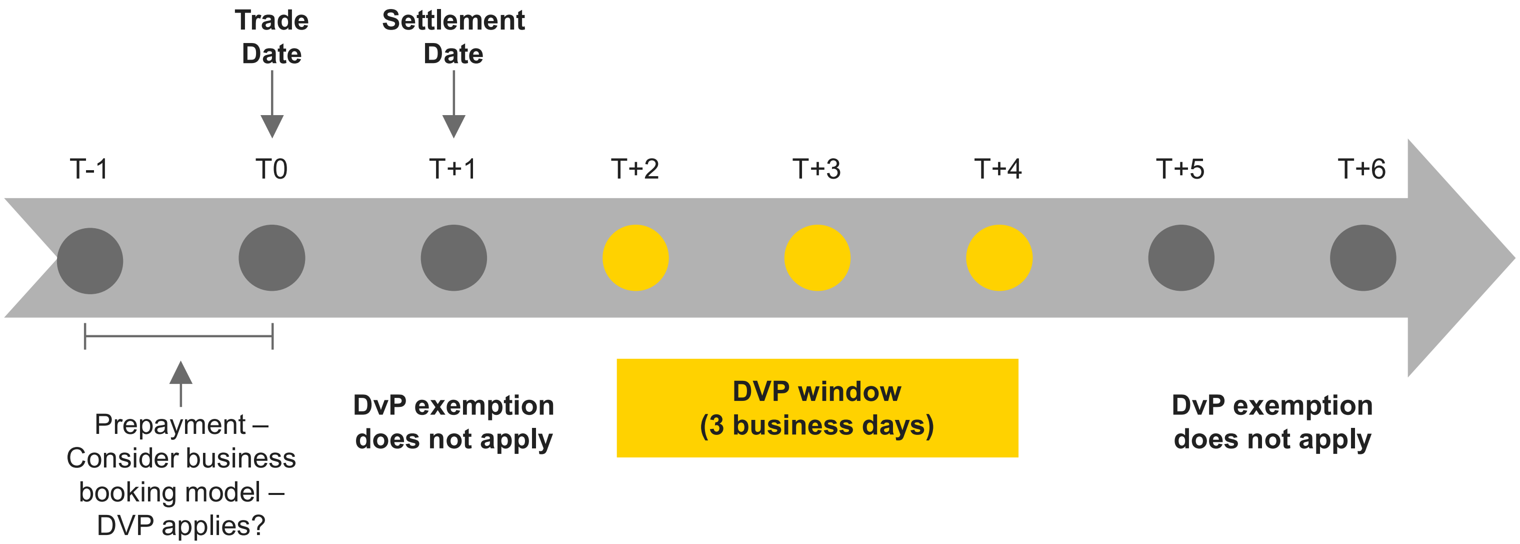
- **Banking Exemption:**
  - If the client's money is held under the 'banking exemption, for example by an approved bank in an account with itself
  - Notify the clients that the money is held by the firm **as a banker**. Notifications can be done via standard Terms of Business, for example:

Client Money The money held for you is held by the firm as a banker and not as a trustee under the client money rules. If the firm fails, the client money distribution rules will not apply to these sums and so the client will not be entitled to share in any distribution under the client money distribution rules.

  - Explain in its terms of business to the clients the circumstances, if any, under which a firm may cease to hold the money as a banker and will be held by the firm as trustee in accordance with the client money rules.
  - **10 Business Days Rule breaks allocation:** A firm should be able to account to all of its clients for sums held for them at all times and the money should be allocated to the relevant client 'promptly'. This should be done no later than 10 business days.

CASS 6 and 7 - Delivery-versus-payment (DVP) exemption

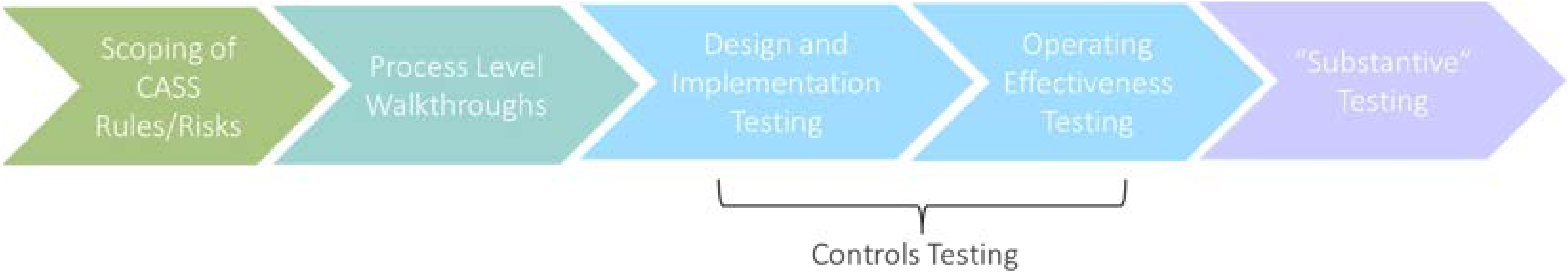
- A firm has the duration of the 'DVP window' where it need <u>not</u> comply with the custody (CASS 6) and client money (CASS 7) rules.
- The DVP window starts from the settlement date and closes at the earlier of the date the relevant DVP transaction settles or the 3rd business day after the settlement date.
- Firms are required to ensure clients agree in writing to the holding of its assets or monies within the DVP window.



Testing Approach

James Edwards, Deloitte

The Testing Cycle



Scoping of CASS rules & Risks – Understanding what the firm does and how client money/assets can arise (FRC Standard para 11).

Walkthroughs – Detailed sessions focused on understanding a firms process for a particular aspect of its business - e.g. how it performs its Internal Client Money Reconciliations.

Controls Testing – Making an assessment on the suitability of the design and implementation of the firms key CASS controls and subsequently testing the operating effectiveness of these controls for our overall opinion.

"Substantive" Testing – Perform any additional non-controls tests that might be required to support the auditors opinion that the firm was in compliance with the CASS rules at the period end.

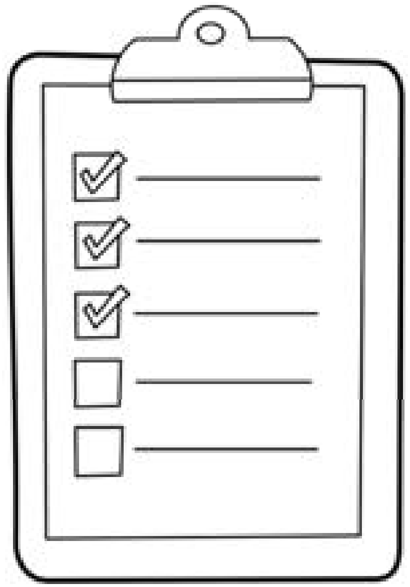
Process Level Walkthroughs

Once we have obtained an understanding of the firms' activities and have made our initial assessment of the applicable CASS rules and risks we can progress through to holding process level walkthroughs.

FRC Assurance Standard Para 11: *"The CASS auditor shall obtain an understanding of the firm's business model that is sufficient to enable the CASS auditor to establish expectations about the existence or otherwise of client assets…"*

When a firm is explaining a process remember the Four W's:

- Who – is performing the steps
- What – are they doing
- When – what is the timing (can be crucial for CASS compliance)
- How – is it being documented and evidenced



Litmus test: Could you walk away and explain in simple terms what the firm does?

Controls Testing – Design

What is the purpose of the control? Is it suitable and does it correlate to the specific risk that it is trying to mitigate?

- What activity /action / outcome will the control stop happening / ensure happens? Does this mitigate the Risk?

Level of aggregation and predictability

- Does the control operate at the appropriate level of aggregation?
- Is the information used in the control predictable enough to allow the control to be effective?

Criteria for investigation and process for follow-up

- What does the control owner investigate and why, and is this appropriate?

Competence and authority of person(s) performing control

- Does the control owner have the knowledge and understanding to operate the control effectively?
- Do they have the necessary authority within the organisation to take the appropriate action required to operate the control effectively?

Frequency and consistency with which control is performed

- Does the frequency of the control make sense in the context of the process within which it sits?
- Is the control performed in the same way every time it operates?

Controls Testing – Implementation and Operating Effectiveness

Implementation Testing

- Testing to validate that the control has been implemented as designed.
- In practice this is often performed as part of the Operating Effectiveness testing.

Sample Testing

- Request evidence of a sample of 'Controls' completed in the period.
- Number of samples will depend on the number of the times the control operated in the period (e.g. more samples for a daily control than a monthly control)
- Additionally, controls in a 'Higher Risk' area will generally result in a higher sample size.

IT Controls

- Operating Effectiveness is proved through fewer samples than with manual controls – in combination with General IT Controls Testing verifying that the system has appropriate IT controls (e.g. user access).

Input Testing

- Controls commonly have inputs they rely on such as canned reports or data-feeds. The CASS auditor needs to gain assurance over the completeness and accuracy of these inputs

Substantive Testing

Substantive testing refers to tests of detail over a particular area of CASS compliance at the period that are not control tests.

FRC Assurance Standard Para 112 provides some examples of such tests as:

- Examining contractual terms
- Testing reconciliations as at the period end date
- Obtaining external confirmation letters
- Checking whether acknowledgement letters have been obtained and are in place at period end

The extent of substantive testing is a function of the conclusions reached through control testing

The CASS auditor must exercise professional judgement in determining the nature, timing and extent of additional substantive testing required beyond the control testing performed that is required.

Overall between controls and substantive testing the CASS auditor must obtain sufficient, appropriate audit evidence upon which to draw their conclusions.

Examples of testing – External Custody Reconciliation

Scoping and Risk Assessment

The firm holds safe custody assets for its clients, and is therefore in scope to perform an external custody reconciliation.

Process Level Walkthrough

The CASS auditor performs a **process level walkthrough** of the firm's external custody reconciliation process to gain an understanding of this process and assess the level of risk it presents.

Design, Implementation and Operating Effectiveness of Controls

The CASS auditor identifies a key control as being the reperformance of the daily external reconciliation.

Hence the CASS auditor assesses the **Design** of this control* as well as its **Implementation**.

Once the CASS auditor is satisfied over the design and implementation of the control they then move on to test the **Operating Effectiveness** of the control using the CASS audit firms control testing methodology.

Substantive Testing

Finally, the CASS auditor performs a circularisation to the firms custodian to gain independent evidence over the balances held by that custodian as a form of "substantive" testing.

* A key component of the reconciliation is a report generated by one of the firms' internal systems – the CASS auditor identifies this and tests the completeness and accuracy of the report

Topical issues

Edward Westrip, Mazars

Some Topical Areas

Where technical interpretation & judgement is required

Edward Westrip

30 January 2024

mazars

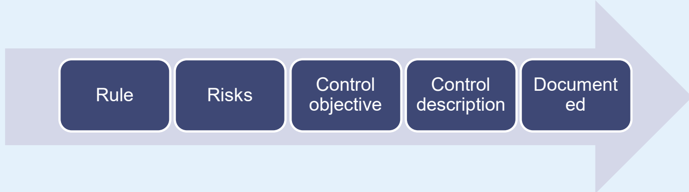
Topical areas

Technical interpretation and judgement in CASS

- Reporting directly upon the rules
- Rules have not been comprehensively revised for some time now
  - Investment firms – 2014 & 2015 (PS 14/9) plus 2021 for MiFID II
  - General insurance intermediaries – 2005 plus 2018 for IDD
- Protection through the customer journey for all flows of monies and assets
- Firm must proactively identify when risks arise which threaten the protection
- Some rules require significant technical interpretation and judgement in complying with by a firm and evaluating compliance by an auditor
- Firms must have adequate organisation arrangements and so have documents the technical interpretation and judgements they make
- We are going to look at a few of these more challenging areas of CASS compliance

TOP TIPS

- Identifying failure to identify or mitigate a risk to compliance



- As much interested in what the firm is not doing but ought to be doing
- Not simply reporting upon what the firm has put in place
- This requires technical interpretation and judgement
- Remember that reconciliations are a detect control and a good system should prevent shortfalls

Topical areas

Prudent segregation

- Duty to minimise risk of loss or diminution of client money
- This requires identification of risks when a shortfall could arise
- Prudent segregation allows a firm to pay in its own monies to mitigate a shortfall should a risk crystallise
- On insolvency this money would be client money available to cover shortfalls
- Requires a policy setting out the risks, why prudent segregation is a reasonable means of addressing each risk and method to calculate the amount to be segregated
- Monies paid in or withdrawn must be recorded in a 'prudent segregation record'
- Monies can only be withdrawn as an excess in an internal reconciliation
- When a new risk arises can pay in monies and update/create the policy as soon as reasonably practicable
- Policy must not conflict with the rules

CASS 7.13.40A R to 53 R

TOP TIPS

- Examples are the risk of systems failure, or business conducted on a day on which a top-up of client money could not be performed such as a UK weekend or bank holiday (CP 13/5 - 4.85 and CASS 7.12.47 G)
- Firms have been using prudent segregation wider than PS 14/9 intended
- Must not use as excuse to not fix an underlying operational issue causing a shortfall and associated breach
- Where payment is made before receiving funds from the client and this is through a client bank account the firm may be able to use prudent segregation to mitigate risk (PS 14/9 - 7.137)

Topical areas

Title transfer collateral arrangements

- Client transfers full ownership of money or assets to the firm
- This is for the purpose of securing or otherwise covering present or future, actual, contingent or prospective obligations
- These obligations can arise for example in connection with margined transactions, stock lending and repurchase agreements ('repo')
- These are prohibited for retail clients i.e. only professional clients which may be elective or per se
- Written agreements which are often in industry standard forms and risks and effects must be highlighted
- MiFID II strengthened the rules in requiring a proper consideration of the use of TTCAs in the context of the relationship and in considering the appropriateness of their use whether the connection is weak or the probability low or negligible, the extent of any excess and whether the client might have no obligations and whether all monies are subject to TTCA

CASS 6.1.6 R to 9 G & 7.11.1 R to 13 R

TOP TIPS

- Read the rules in detail
- Often used where the firm is willing to give credit to the client
- The guidance tells the firm to remember the client's best interest rule
- Firms must have a documented policy and require both quantitative as well as qualitative analysis of when it is no longer appropriate for monies to be held under the TTCA
- Any excess must be segregated or returned (the latter being operationally challenging)
- There is no de-minimis excess or minimum transfer
- CASS 3 can apply

Topical areas

Payment service providers – A CASS practitioner's perspective

- Some investment firms collect monies from clients via a non-bank payment services provider ('PSP')
- Authorised payment institutions are required to use either a segregated account or an appropriate insurance policy or comparable guarantee to protect monies
- Relevant funds are those received for the execution of a payment transaction
- The segregation applies 'if the funds are still held at the end of the business day following the day on which they were received'
- This means monies in transit from the client to the firm are not received into a client bank account and may not be protected before they are required to be segregated at the PSP

CASS 7.13.6 R

TOP TIPS

- Need to understand PSPs used by firms and what the firm has done to understand how or whether monies are protected
- Monies received into a PSP could be considered a breach of the normal approach to the segregation of client money, which requires monies to be paid directly into a client bank account
- Some firms are using prudent segregation against the risk on insolvency
- Risk of insolvency of PSP is In demonstrated by the coming into force of special administration rules
- Small PIs are subject to Principle 10 ('duty to protect') and may not have safeguarding arrangements in place

Topical areas

Issues with some exemptions

- TTCA – see previous slide
- Delivery versus payment for authorised fund managers
  - Monies paid to clients or funds from an office account
  - Returned monies are received into the office account
  - This is a breach of the normal approach to segregation
- Temporary handling of custody assets
  - The rules give a context ‘In most transactions this would be no longer than one business day, but it may be longer or shorter depending upon the transaction in question’
  - Judgement is required as to when the exemption is no longer appropriate or why not simply applying CASS 6
- Banking exemption
  - Breaches do not give rise to client monies
  - Have seen situation where DIB is conducted for persons with whom the firm does not have a banking relationship

CASS 7.11.21 R to 24 R, CASS 6.1.15 R to 16 G, CASS 7.10.16 R to 24 R

TOP TIPS

- Need to make sure that firms have evaluated whether an exemption is appropriate and in the best interests of clients and have controls to prevent and detect when any exemption is breached
- Use of an exemption may result in a breach where the firm or auditor judges that its use is inappropriate
- Professional scepticism is particularly required where a firm is claiming the use of an exemption as the basis for not applying CASS in total or to a business/product segment.

Topical areas

Limited assurance breaches – how we capture them

- The client asset assurance standard requires an understanding of the business model and where client money or assets could arise and if applicable why a firm is not using a permission
  - In many instances the firm is not involved in the flows of assets and monies and they will likely only be held through administrative or operational errors
  - For usually more complex business models they can also be held through poor contracting or the failure to adhere to exemptions
- Firms should have evaluated the risks of monies or assets arising and designed and implemented controls and monitoring which are effective to prevent and identify where monies or assets are held
- This also requires the firm's staff to be trained
- Follow the testing set out in the standard which includes capturing where controls or the statutory audit have identified any incidents of holding client assets and documentary review

Modifications & Breach of Permission

TOP TIPS

- The firm should have itself identified when its controls and monitoring identify monies and assets are held
- It should also have an effective process for capturing and evaluating these and also whether potential incidents/near misses require improvements
- Modifications may need the firm to evaluate whether it needs permission or should apply CASS

Topical areas

Limited assurance breaches – examples

- Over calculation of fees and other charges
- Invoice preparation errors or billing more than once or after relationship/service has ended
- Client paying the same fee more than once
- Not paying rebates or compensation (DIB loss, not ‘hurt feelings’) when due and payable
- Investment monies sent to the firm’s account
- Distributions/other corporate actions mis-routed
- Interest due to clients paid to wrong account
- Holding out as the custodian as part of the service
- Tax reclaims can be problematic (particularly for SIPP providers using bare trusts)
- Shares held and administered (sometimes for VC)
- And breach of exemptions (see previous slides)

Modifications & Breach of Permission

TOP TIPS

- These are much broader than simply fee or charge errors
- Ensure the team is briefed and knows what they are looking for
- Take care on the boundary between DIB and other business, for example, collateral held against a loan or GII monies upon which we are not reporting
- Take care in complex situations with many entities and other providers as to who is accountable to the client for what
- Client agreements that do not deal properly with compensation or rebates easily lead to breaches
- Using an emphasis of matter for banking exemption requires FCA permission

Reporting and Forming our Opinion

Shermeen Kazmi, Grant Thornton

Reporting breaches

- Breaches Schedule attached to every reasonable assurance report
- Every breach of a rule to be reported
  - only those rules within the scope of the report
  - identified by CASS auditor, the firm, or a third party
- Any breach = not a clean opinion
- The materiality or significance of a breach of the CASS rules are not relevant considerations in determining whether the breach of a CASS rule needs to be reported

What makes good breach reporting?

clarity – needs to be understood by the reader, and given context, for example:

- how frequent?
- how many transactions affected?
- when?
- for how long?
- what was the amount involved or at risk?
- how many client bank accounts involved?
- how many client securities involved?
- if the breach is carried forward from the prior period or identified in the current period
- if breach was closed during the period or still open at period end
- if a guidance is not complied with, the accompanying rule breached

Assessing Significance of Issues

FRC Standard: *Where the CASS auditor determines that a modified opinion is required it shall determine whether to issue an "except for" or an "adverse" opinion,* based on*:*

- *The significance of a rule breach, as well as its context, duration and incidence of repetition*
- *The aggregate effect of any breaches*

Inability to obtain sufficient, appropriate assurance evidence to form an opinion can lead to inability to form an opinion

The need for an adverse opinion

FRC Standard: *Identified weaknesses in control and/or breaches of rules are systemic, or pervasive, as opposed to isolated incidents. If the firm's system design is significantly flawed or repeatedly fails, an adverse opinion is likely to be appropriate.*

Particular areas the CASS auditor considers which might give rise to an adverse opinion include:

- *The extent to which clients might have lost their assets/money if the firm had gone into administration while the breach persisted*
- *Whether there had been a breach of the requirement to keep proper records of client assets*
- *Whether the firm had failed to carry out, or incorrectly carried out to a significant extent, the reconciliations required by the CASS rules.*

Reporting Control deficiencies

Reported in a Findings Report to management and those charged with governance:

- Report findings that pose the most significant risk of non-compliance with CASS rules
- Findings relating to deficiencies in internal control in both the current period and the prior period that, whilst have not resulted in a breach, could be improved upon
- Findings that require the most urgent resolution to reduce risk of non-compliance

Control findings can become a breach if the firm has taken no action from the prior year.

Grant Thornton

Statutory duty to report

- A duty imposed by law on the auditor of an FCA or PRA authorised firm
- If we reasonably believe that:
  - There has been contravention of a relevant requirement that may be of **material significance** to the FCA in deciding what action it should take
  - Matters may be of material significance in determining whether the entity satisfies and will continue to satisfy the 'threshold conditions'
- Communication is necessary when the auditor becomes aware of matters

Grant Thornton

Reporting Direct to the FCA

- Anticipate to issue an adverse opinion
- Notification in respect of firm not appointing an auditor to carry out a CASS audit
- Notification in respect of a firm carrying business outside its permissions
- Instances of fraud in relation to client money

If the breach is of material significance to the FCA, auditor does not have to wait to report via a breaches schedule.

Quality Control

Competence, capability and training

- Framework to comply with applicable standards and guidance set out in ISQC(UK)1
- CASS engagement team to have sufficient competence and capabilities to perform the audits
- CASS engagement team has the relevant experience and training in respect of client asset work

Engagement Quality Control Review

- A process designed to provide an objective evaluation, on or before the date of the report of:
  - The significant judgements made by the CASS engagement team; and
  - The conclusions reached in formulating the report
- All CASS Medium and Large investment business firms are subject to EQCR
- For all CASS engagements, the reasons for performing or not performing an EQCR must be documented

Modified assurance opinions are subject to internal, independent review by FCA assurance specialists.

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