To: Portfolio Company Management

From: Omega Venture Partners

Re: Cash Management Best Practices

One of your most critical responsibilities is managing the cash risk of your organization. Effective cash risk management can help ensure that your company has the necessary liquidity to support operations, fund growth initiatives, and weather unforeseen economic shocks. Cash is the lifeblood of your organization and running out of cash (for any reason) can be a terminal event.

The construction of reliable systems from unreliable components is one of the most important objectives of systems engineering. In this memo we reference core computer system design principles in presenting best practices to consider when structuring your banking accounts for cash risk management.

Starting from first principles, understand that systems fail because of faults. A fault is an underlying defect, imperfection, or flaw that has the potential to cause problems, whether it actually has, has not, or ever will. When one or more faults result in a failure, problems happen.

Clearly, one way to design a reliable system would be to build it entirely of components that are individually so reliable that their chance of failure can be neglected. This technique is known as *fault avoidance*. Unfortunately, it is hard to apply this technique to every component of a large system. In addition, the sheer number of components may defeat the strategy. Therefore, the pragmatic alternative is to apply various techniques that are known collectively by the name *fault tolerance*.

Here are some ways in which you can create a fault-tolerant design for your banking and cash management:

1. Maintain Multiple Banking Relationships.

You should maintain multiple banking relationships for redundancy and failover. Maintaining relationships with multiple banks can help mitigate the risk of bank failures, disruptions in banking services, or systemic banking crises. Splitting your cash balances across several banks and maintaining good relationships with each of them can ensure that you have access to liquidity from different sources in case of any disruptions.

If one bank experiences issues, you can quickly move your cash balances to another bank, or access funds from another bank, to maintain your liquidity. Multiple bank accounts also enable automatic failover for your receivables, giving you the flexibility to update where customer payments are deposited so that you can access these funds.

2. Make Your Banking Relationships as Independent and Uncorrelated as Possible.

Your banking relationships should be at banks that are as uncorrelated as possible (e.g., by size, geography, and industry exposure). In practice, if you use a regional bank as your primary partner, your backup banking relationship should be with a national money-center bank[1].

Similarly, diversifying the types of bank accounts used for cash management can help mitigate risk. Depending on your cash needs, you should evaluate different types of accounts such as checking, savings, and money market accounts. Each of these accounts has varying levels of liquidity and risk, so it is important to determine which account best suits your cash management needs. For instance, a savings account might provide higher interest rates but lower liquidity than a checking account. On the other hand, a money market account might offer higher liquidity but carry some risk of breaking its stable value peg.

[1] Money Center banks access capital through money markets instead of deposits. For example, JP Morgan Chase, Bank of America, Wells Fargo, Citibank, HSBC are money center banks.

3. Use FDIC-Insured Cash Sweep (ICS) Account(s) to Extend FDIC Insurance Coverage to Large Deposit Balances.

Bank accounts are typically insured up to $250,000 by the FDIC. For most businesses this is inadequate. However, with an Insured Cash Sweep (ICS) account, you can access FDIC Insurance above $250,000 (and up to $100 million) through a single bank relationship.

If you structure your deposit account as an FDIC-Insured Cash Sweep account, your money will be stored within demand deposit accounts or money market deposit accounts at other ICS Network banks, each of which is FDIC insured. In essence your primary bank will automatically slice up your deposit into sub-deposits at a vast network of institutions, each of which is FDIC insured, but you will still have a single login / dashboard to view and manage your money in one place.

4. Use Cash Brokerage Accounts and Treasury Securities.

While an ICS account is going to be the best option for most businesses, an alternative is to open a cash (not margin) brokerage account and invest your cash in a ladder of Treasury securities (e.g., short duration T-bills). These T-bill are held in your company's name and are direct obligations of the US government payable to your company.

The SEC's Customer Protection Rule safeguards customer assets at brokerage firms by preventing firms from using customer assets to finance their own proprietary businesses. In the event that the brokerage should become insolvent, these segregated securities are not available to the brokerage's general creditors and are protected against creditors' claims.

You want this account to be in your company's name because if the underlying assets (T-bills) are held by a third-party entity that you do not have direct access to, you may be unable to unilaterally liquidate or access those assets. Simply put make sure you have co-custody along with the underlying custodian (the entity that is the holder of record of the underlying assets for safekeeping).

The reason you want to have a cash (not margin) account is for safety. In many margin accounts, you sign an agreement that in theory gives your brokerage the ability to lend or borrow against a portion of your securities pursuant to the loan consent provision of your account agreement. Most companies have no need to take on this extra risk.

5. Implement Dual Control Procedures.

Dual control procedures involve having multiple individuals responsible for authorizing and executing financial transactions. This practice helps mitigate the risk of internal fraud and ensures that financial transactions are appropriately monitored and reviewed.

Dual control procedures should be implemented for all financial transactions, including wire transfers, ACH transactions, and check payments. For example, in a small company, the CEO can authorize a payment, but the payment should be executed by someone else, such as the CFO or controller.

6. Adopt a Layered Approach to Cybersecurity.

With the increasing threat of cyber attacks, it is essential to have robust cybersecurity measures in place to protect your cash balances. A layered approach to cybersecurity involves implementing multiple layers of security, such as firewalls, intrusion detection systems, and multi-factor authentication. It is also essential to educate your employees on cybersecurity best practices, such as not sharing passwords or clicking on suspicious links.

In principle, you should perform regular vulnerability assessments and penetration testing to identify potential weaknesses in your cybersecurity infrastructure. In practice, recognize that the major risk comes from Phishing emails that entice your key employees from entering credentials in an imposter website.

7. Conduct Regular Bank Reconciliations.

Regular bank reconciliations are essential to ensure that your cash balances are accurate, and there are no discrepancies between your accounting records and bank statements. Bank reconciliations should be performed on a monthly basis or more frequently, depending on the volume of your transactions. This practice helps identify any errors or discrepancies in your cash balances, which can be corrected promptly. Additionally, bank reconciliations can identify any unauthorized transactions or fraudulent activities, which can be investigated immediately.

8. Maintain a Reasonable Cash Reserve.

Maintaining a cash reserve – typically at least 3 months – is essential to mitigate the risk of unexpected cash outflows or revenue shortfalls. A cash reserve can help ensure that your organization has sufficient liquidity to support operations when you need it most. The size of the cash reserve should be based on the company's cash flow requirements, the level of risk associated with the industry, and the organization's risk tolerance. The cash reserve should be kept in a highly liquid account, such as a savings account or money market account.

9. Create an Investment Policy.

Put an investment policy in place to ensure that any extra cash is utilized effectively and in alignment with your company's long-term goals. A simple and straightforward investment policy should outline the objectives, strategies, and criteria for investing excess company funds. An investment policy helps ensure that you have a conscious and proactive approach towards managing cash and is a forcing function to implement sufficient controls to regulate how, why, and by whom cash can be accessed, moved, manipulated, or deployed. Practically speaking, unless you are operating an investment firm, your investment policy codifies common sense principles associated with ensuring that cash is deployed in instruments that align with your liquidity and principal preservation requirements.

Best regards,

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