

24 July 2020

Dear CEO

Inappropriate use of title transfer collateral arrangements ('TTCAs') and regulatory permissions for financing transactions

We are sending this letter to you and other FCA-authorized firms acting as brokers in wholesale financial markets, who currently, or may in the future, offer services (including clearing broker and prime broker services) that involve holding clients' cash or securities as collateral.

In this context, it is common market practice to enter into TTCAs with clients over that collateral, allowing firms to use the cash or securities to secure obligations owed to them by their clients. Outside such arrangements, cash and securities given to the firm when providing investment services to a client are likely to be client money or custody assets under the CASS regime. In all cases firms must ensure compliance with any applicable CASS rules, including obligations in relation to the use of TTCAs and the correct application of the exclusions in CASS for TTCAs.

We have recently identified examples of inappropriate use of TTCAs by firms, amounting to failures of CASS compliance. We are asking you to review the use of TTCAs in your own firm's business and have appended details of what we deem to be inappropriate use of TTCAs for the attention of the Senior Manager within your firm who has responsibility for client assets or alternatively (for those firms without CASS permissions), the Senior Manager responsible for Compliance. We also remind you that, under SUP 15.3.11R(1)(A) it is mandatory to disclose any significant breach of a rule and therefore your firm must notify us should any rule breaches be identified in its approach to CASS compliance regarding TTCAs.

Additionally, we have seen examples of these same types of firms incorrectly classifying financial transactions as falling within the prudential matched principal exemption, and thus holding lower financial resources than may be required and also acting outside the limitations of their regulatory permissions.

Harm we are concerned about

Protection of client money and custody assets (collectively 'client assets') is a long-standing priority for the FCA, and it is particularly important during the current coronavirus situation given the increased risk of client defaults and firm failures. It is also important that firms act with integrity and due skill, care and diligence (cf. the FCA Principles for Businesses 1 and 2), including in relation to their obligations to clients.

Clients whose assets are subject to TTCAs will usually rank as general creditors of the failed firm's estate in respect of their claims for repayment of collateral. Consequently, they may experience a shortfall or delay in having their assets returned from the general estate, rather than benefitting from the protections afforded by CASS. This makes it especially important that firms only take collateral by a TTCA where permitted, and comply fully with the CASS rules when they do, to avoid any adverse effect on clients in the event of an insolvency.

Regulatory permissions for financing transactions

We are also reminding firms with business models that use TTCAs to hold collateral for leveraged client trading, that it is their responsibility to ensure they have the correct regulatory permissions for the activities they undertake, including considering whether they can genuinely rely on the matched principal exemption for prudential categorisation purposes. Failure to apply the correct prudential treatment could result in a firm incorrectly holding lower financial resources than may be required and failing to comply with rules that would otherwise apply. This could mean that the firm faces a greater risk of disorderly failure and resultant potential harm to consumers and markets.

Next steps – please act

Please reply to wholesalebrokers-ttca@fca.org.uk by 14 August 2020, confirming that the Senior Manager with responsibility for client assets, or alternatively the Senior Manager responsible for Compliance, has considered the issues in the appendix and will bring any issues to the attention of its Board.

As noted above, if any rule breaches are identified in relation to your firm's use of TTCAs or regulatory permissions, immediate steps should be taken to rectify them and you should notify us accordingly.

If you have any questions about this letter please contact the Supervision Hub or your named supervisor.

Yours sincerely

Marc Teasdale
Director of Wholesale Supervision
Supervision Investment, Wholesale & Specialists Division

Appendix

This appendix is to remind you that:

- the exemptions in the FCA's Client Assets Sourcebook (CASS) for security arrangements are limited;
- the use of TTCAs is subject to a number of obligations within CASS in order to protect clients (see especially CASS 7.11.1R – 7.11.13G and CASS 6.1.6R – 6.1.9G and CASS 3); and

to ask you to check that you have all necessary permissions in relation to the regulated activities undertaken and are compliant with any requirements imposed on your firm. Here we highlight a concern that some firms have not done so in relation to financing transactions.

Recent examples of inappropriate use of TTCA

We have recently seen inappropriate use of TTCAs, including firms:

- holding money or assets under a TTCA without meeting the requirement to consider client obligations;
- holding all of a client's money or assets under a TTCA in the absence of a present, future, actual, contingent or prospective obligation to the firm;
- holding an inappropriate amount of money or assets under a TTCA compared to that client's present, future, actual, contingent or prospective obligations;
- moving an increased amount of collateral from a segregated (CASS) to a TTCA (non-CASS) environment without a corresponding documented consideration demonstrating a connection between the collateral taken and the relevant client obligation.

We are especially concerned about such cases where firms lacked arrangements to promptly return collateral to their clients, or to segregate it as required by CASS. This includes firms that did not have the relevant permission where they were safeguarding and administering investments or which were subject to a requirement preventing them from holding client money.

Where we have identified inappropriate uses of TTCAs, we have taken steps to ensure firms have addressed any non-compliance with their obligations under CASS.

Impact of financing transactions on prudential classifications

We have seen some firms seeking to classify particular types of financing arrangements as matched principal trading in order to rely on the modified prudential treatment in BIPRU 1.1.23R or IFPRU 1.1.12R (commonly referred to as the prudential "matched principal exemption" or "MPE"). We believe in some cases this is an incorrect classification. A firm that is genuinely relying on the MPE will need permission to deal as principal. That permission will typically also be subject to a limitation which restricts its ability to carry on that activity to circumstances which satisfy the conditions of the Prudential MPE.

As explained in Question 16 in PERG 13.3, where the prudential MPE applies, a firm will not be treated as dealing on own account for the purposes of its prudential classification (but this does not affect the classification of that activity for general MiFID purposes). However, simply because a firm's trading activities may fall within the concept of matched principal trading as further explained in recital 24 of MiFID, and therefore may not result in any net position risk, does not of itself mean that such investment activity would fall within the prudential MPE. All of the detailed requirements set out in BIPRU 1.1.23R or IFPRU 1.1.12R (as applicable) must be satisfied for the exemption to apply.

We understand that firms using TTCAs to hold collateral for leveraged client trading will sometimes enter into financing transactions such as sale and repurchase agreements (repo trades) to generate funding in support of the services they are providing. We have seen certain firms seeking to rely on the prudential MPE in relation to such arrangements. We believe this is a mischaracterisation of the nature of the funding transaction and that such arrangements are unlikely to satisfy the conditions for the exemption (and where applicable, any associated limitation on the firm's permission).

Additionally, firms that offer margin trading by dealing in their own name (even on behalf of clients) can become exposed to market prices and risk where clients default on margin calls, such as where the broker has its own corresponding obligations to a clearing house or clearing bank. Such exposures typically exist until positions can be closed out with the clearing house or clearing bank. We have seen some firms seeking to characterise this as falling within scope of the prudential MPE. Again, we believe that many of these arrangements are unlikely to meet the necessary conditions for the exemption to apply (and where applicable, to comply with any associated limitation on the firm's permission).

Firms that have been incorrectly relying on the MPE should notify the FCA immediately in order to update their prudential classifications and, where necessary, will need to apply to remove any limitation on their permissions designed to reflect the MPE. In addition, firms should check that they have all necessary permissions in relation to the regulated activities they undertake and are complying with any requirements imposed on the firm. Where this is not the case, the firm will need to cease the relevant activities and apply to the FCA to vary its permissions and/or requirements accordingly.

We would also take this opportunity to remind firms of our Discussion Paper DP20/2 'A new prudential regime for MiFID investment firms' and in particular paragraph 3.4 of that DP which concerns the potential future of the MPE. Further, Figure 11.2 of the DP also identifies TTCAs as an example of where we might expect investment firms to consider the potential for harm to clients that could arise from inappropriate control of such arrangements under such a new prudential regime.