

## Title Transfer Collateral Arrangements – FSA takes away the punchbowl

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In its quarterly consultation paper (CP 10/15), the FSA formally announced its intention to prevent investment firms using title transfer collateral arrangements (TTCAs) with retail clients.

TTCAs are utilised by derivatives firms that enter into margined transactions with clients – primarily contracts for differences (CFD) and spread betting firms in the context of retail clients. TTCAs allow those firms to treat margin (the amount paid by the client as collateral to open the position or bet) as their own working capital, rather than client money (which must be segregated). Often, those firms subsequently use that money to fund their hedging arrangements, or other business ventures. In the event of a firm's insolvency, margin money that fell under a TTCA would be recoverable only on an unsecured creditor basis (rather than a ring-fenced trust basis), and might therefore be irrecoverable if the firm has no assets to distribute on insolvency.

Despite the fact that MiFID and the current FSA guidance appears to permit the use of TTCAs for all types of client, the FSA now views them as an unacceptable risk in the context of retail clients, who are not deemed to have the ability to understand the insolvency risk, and who should be therefore given better protection.

This move, which is part of a wider FSA programme to overhaul the client money rules and reduce the risk of irrecoverability of client money on a firm's insolvency, is likely to have serious implications for the treasury arrangements of CFD and spread betting firms, and may have further unintended consequences.

### **What is happening?**

The FSA has proposed a change to the rules in its client assets sourcebook (CASS) that relate to title transfer collateral arrangements (TTCAs), specifically CASS 6.1.6R (in respect of assets) and CASS 7.2.3R (in respect of cash). These rules will be amended to prohibit firms from using TTCAs with retail clients.

In addition, the FSA has proposed additional guidance around the calculation of the amount of client money that a firm needs to segregate in relation to margined transactions, which is intended to have the effect that firms segregate margin as client money.

Following the rule changes, firms that enter into margined transactions with retail clients, such as CFD and spread betting firms, will no longer be able to use retail client margin to fund their own activities. Instead, such margin will have to be treated as client money (and segregated).

Once the rule changes are finalised, Firms will have a one-month transitional period to amend their client contracts and make adequate preparations.

The consultation paper does not propose a timeframe for the rule change. Responses to the consultation paper are required to be submitted by 6 September 2010, so we assume that FSA intends to change the rules shortly after that date.

### **Why is it happening?**

The FSA has been nervous about the use of TTCAs since the implementation of MiFID in November 2007.

Prior to MiFID, retail clients (then known as private clients) were given full client money protection – all margin for retail clients was required to be segregated as client money. CFD and spread bet firms would often be able to avoid this by recategorising their clients as professional clients (then known as intermediate customers) on the basis that they were deemed to be 'experts'. Those clients could then be opted-out from client money protection, in a way that was compliant.

Following the implementation of MiFID, the concept of the client money opt-out was removed. All categories of client were to be given full client money protection. However, a recital in MiFID allowed for an exception to this rule – this permitted money falling under a TTCA to be exempt from client money treatment. In effect, MiFID retained the opt-out in respect of collateral (such as margin), and permitted the exception to be used for any class of client.

At the time, the FSA steered away from 'gold-plating' MiFID by preventing firms from using TTCAs with retail clients, but instead gave guidance as to how firms should use TTCAs to ensure that they were still acting in the best interests of retail clients (which was another MiFID requirement). This included, for example, only using TTCAs in respect of a client's current margin requirement, as opposed to deeming entire client money balances as collateral falling under the TTCA. The FSA

also told the industry that it would have concerns if firms used the flexibility awarded by MiFID to avoid providing client money protection to retail clients.

During the course of 2009 the FSA visited several CFD and spread betting firms and discovered that the use of TTCAs with retail clients was widespread and, in the FSA's opinion, dangerous. The FSA wrote to those firms making it clear that it felt they were 'pushing the envelope' too far. In the consultation paper the FSA specifically criticises firms that use TTCAs to remove client money from the scope of the client money rules so that they can use it to finance their own business activities. The FSA argues that where those activities are particularly risky, the overall protection given to clients is significantly reduced, since the chances of recovery of that money as a general creditor might be low.

Whilst the FSA feels that professional clients and eligible counterparties are well equipped to understand and evaluate this risk, it considers that retail clients should not be assumed to be capable to make a same judgement (despite the use of 'risk warning notices' which would usually explain the risks to clients).

The proposed new guidance around client money accounting processes is in response to a practice that some firms appear to have adopted to avoid segregating margin (even where there was no TTCA in place). This involves deeming margin as money that is 'due and payable' to the firm (that does not need to be segregated) rather than as money that they would be liable to pay back to a client if their position or bet was liquidated at the close of business price (that does need to be segregated). The FSA emphasises that this is not a rule change (i.e. it was always required) and reminds auditors signing off on those accounting processes that they will be required to verify that adequate protection is afforded at all times.

### **What will be the impact if the rule changes go ahead?**

These rule changes will only affect derivatives (CFD and spread bet) providers that are authorised as investment firms. CFD and spread bet businesses operated by deposit-taking firms (banks) will continue to be outside the scope of the client money rules - all money placed by clients with those firms can be treated as deposits rather than segregated client money. Also, according to the FSA, over half of UK CFD and spread betting firms that are investment firms do not use TTCAs in any case. Other than removing the possibility that they may do so in the future, the rule changes would also have little impact on those firms.

This leaves the CFD and spread betting firms that are investment firms who currently make use of TTCAs. They will need to consider the liquidity impact of the rule changes, specifically whether or not they can continue operate business as usual following the switch to full segregation. Certain strategies may be available to them:

- Firms may undertake reviews of client files to determine how many of their current retail clients could be recategorised as 'elective professional clients' (with their consent). The stricter qualitative and quantitative means-testing in the current post-MiFID conduct of business rules make this process more difficult than the pre-MiFID recategorisation process. The FSA has also warned that it will be vigilant to any abuse of this process since this would reduce the protection given to any qualifying retail clients that agreed to be recategorised.
- Firms may need to consider alternative means of financing their operations, or reducing the costs of those. This is particularly relevant to firms that use margin to fund proprietary trading (including hedging books to manage the risk of client trades). Indeed, if firms choose to take riskier positions to reduce costs, this may have an unforeseen impact on the FSA's objectives of consumer protection and market stability. In addition, firms may be less inclined to credit client's balances with interest earned on the relevant client money bank accounts, and will instead claim such interest as their own – although given current interest rates this is unlikely to have a significant immediate impact.
- Firms may also consider, in light of the rule changes, whether or not the benefits of being a deposit-taking firm (or part of one) now outweigh the disadvantages (most significantly the higher capital requirements and increasingly stringent regulatory and governance regime). This could potentially create more work for the FSA (or in future, the Bank of England). Whether or not this would be a better consumer outcome would depend on the strength of the deposit-taker.
- The FSA recognises that some firms may not be able to cope with the rule changes and may simply exit the retail arena. The effect of this on competition and consumer choice remains to be seen.

Finally, there is a potentially damaging effect that the rule changes might have in the context of an industry that competes on low margin rates. If certain firms can no longer rely on margin as a source of working capital, they may be less inclined to require margin, or as much margin as they currently require, notwithstanding that margin would still amount to collateral that is set aside to cover client losses. This might lead to a reduction in the rates of margin that firms charge to clients, thereby encouraging customers to have more riskier trading/betting portfolios. This could potentially result in a net negative impact on consumer protection.

### **Can the FSA get away with it?**

At the heart of the rule change is an opinion held by the FSA that MiFID is somewhat contradictory. Whilst MiFID allows TTCAs to be used for all clients, it also requires firms to act in the best interests of clients. The FSA cannot seem to reconcile these two provisions in light of the way the retail market has operated since MiFID. However, the fact that MiFID is required by law to be correctly implemented in the UK may provide scope for a potential legal challenge to the rule change. It remains to be seen as to whether or not the industry will take this approach.

The FSA also asserts that the rule change will affect only the CFD and spread bet industry. This may not necessarily be the case, since other retail clients (such as small businesses) may, from time to time, enter into margined transactions with other types of investment firms (for example commodity derivative firms). If this is widespread then the FSA may need to narrow its proposed rule changes to achieve the desired effect, for example by focussing on individual clients/consumers only.

In any case, formal objections should be raised to the FSA by 6 September 2010. In the meantime, many firms will most likely be preparing for the inevitable.

## Useful links

To read CP 10/15 see [here](#).

The client assets and living wills page on our Regzone contains more useful information relevant to this topic – please see [here](#).

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