

4 August 2023

Dear Chief Executive

Our supervisory strategy for Principal Trading Firms

The FCA takes a strategic view towards sectors or 'portfolios' of firms with similar business models and regulatory permissions. You are receiving this letter because we are setting out our strategy for supervising Principal Trading Firms (PTFs), which is how we categorise your firm. We recognise that these portfolios can be broad and may still encompass a range of different activities such that not all elements of this letter will be relevant to you¹.

This letter details our view of the most important risks arising from PTFs, what we think drives those risks, our expectations of you, and our supervisory focus for the next two years.

We expect you and your Board to discuss the contents of this letter, consider how the risks apply to your business, and take action to manage them effectively.

The role of PTFs

Firms in this portfolio derive the majority proportion of their revenue from trading (dealing) as principal. This may include algorithmic trading, which could be high frequency, as well as market making. The portfolio also includes firms that trade as principal in commodity markets, including financial derivatives, physical commodities, emission allowances and their derivatives.

PTFs play a valuable role in wholesale financial markets both in the UK and globally. They can have a significant impact on liquidity provision and price formation due to their large trading footprint and trading strategies. They are often at the cutting edge of technological developments in financial markets, helping to drive innovation and efficiency. Many act as market makers and therefore play a key role in ensuring the smooth functioning of financial markets, including during stressed conditions. When operating at their best, the automated technology of firms trading algorithmically can bring significant benefits to investors, including increased execution speed and reduced costs. Trading firms operating Systematic Internalisers provide competition to trading venues and may drive better pricing and reduced costs that help their clients achieve best execution.

¹ If you think that few of these risks apply to you and that we may have miscategorised your firm, including if you have a material client-facing business, please let us know.

As a result, PTF activities convey particular responsibilities to the UK and its financial markets. Firms in this portfolio are important stakeholders in the reforms being implemented through the [Wholesale Markets Review](#) and the consultations we are issuing this year, such as the recently published proposals for the establishment of a bond consolidated tape, and our planned consultation on commodity derivatives. Towards the end of the year, we also plan to consult on a review of the transparency regime for bonds and derivatives. We encourage strong industry engagement with our proposals and expect firms to consider how they may be impacted by any changes.

External environment

The portfolio and the financial markets in which they operate have been impacted by external events in recent years, including heightened geopolitical risks, the UK's withdrawal from the European Union, and the Russian invasion of Ukraine. The current challenging macroeconomic environment, and the lingering effects of COVID 19-related impacts, are also likely to be affecting firms in this portfolio in the same way as other market participants. PTFs who specialise in commodity market trading in particular may have been exposed to periods of sustained volatility, high prices leading to substantial margin calls and other higher costs, credit stresses and increased counterparty risks.

In addition, since the beginning of 2022, a number of incidents have underlined the importance to firms of having appropriate systems and controls in place to manage the risks to their businesses. The cyber-attack on ION Markets had a widely felt impact on the trading and clearing of exchange-traded derivatives. It highlighted the key role of critical third-party suppliers and the importance of having appropriate business continuity plans in place. The collapse of one of the largest cryptoasset exchanges in the world, FTX, also highlighted the volatile and unpredictable nature of crypto activity. As this market segment develops, we are aware that some firms in the PTF portfolio are considering their approach to cryptoassets. We expect firms to keep abreast of the latest thinking and approach to cryptoassets, as set out in the [HM Treasury consultation](#) issued on 1 February 2023 for example.

Drivers of harm

Market abuse is an inherent driver of harm among all firms in the portfolio. Inadequate controls, poor market abuse policies, and ineffective or poor leadership from the top could result in instances of market manipulation and disruption. PTFs which have a relatively large trading footprint, and those that utilise algorithmic trading strategies, pose a heightened risk of harm due to these factors.

Many PTFs are highly technology-dependent, and an operational incident at the larger firms in the portfolio has the potential to cause harm to wider markets. These factors place a premium on all firms to ensure they are operationally resilient, including having effective cyber-security. Commodity trading firms, in particular those whose trading supports the physical flow of commodities across their wider group, can pose particular risks to their counterparties and the wider functioning of the financial markets if they have dominant market positions or are large market participants.

While recent periods of sustained volatility and uncertainty have increased financial and operational risks, overall firms in the portfolio have proved relatively resilient. Indeed, PTFs can profit from periods of volatility as price movements may incentivise increased trading, and spreads can be wider. Our ongoing analysis of the sector has not revealed any recent 'flash crash' market events that have been attributed to firms in the portfolio, nor evidence of widespread serious misconduct among PTFs, although we remain on heightened alert around

certain commodity markets. Firms' risk, governance and compliance controls have appeared adequate to deal with market conditions and external challenges. This reflects our view that most UK authorised PTFs are well versed in our expectations and take their regulatory obligations seriously.

However, we have observed that some firms are not sufficiently familiar with our requirements and have weaknesses in their governance and control infrastructure. For a minority of firms in the portfolio, being regulated by the FCA requires a mindset change.

What our supervisory strategy will focus on

With the external context and our recent supervisory experiences in mind, we have identified the following five key areas of focus for our PTF supervisory strategy:

1. Algorithmic trading controls

There are inherent risks in algorithmic trading. It is essential that firms' controls and key oversight functions, including compliance and risk management, keep pace with the ever-increasing complexity and speed of financial markets and technological advancements. This includes developments in artificial intelligence (AI), as well as algorithmic trading tools more generally.

Algorithmic trading is an important part of financial markets, and it is critical that firms consider the market conduct implications of their trading activity and the impact it has on overall market integrity. We expect firms to devote appropriate resources to maintaining effective oversight functions and controls aimed at reducing the impact of any trading incidents on the orderly functioning of the markets they operate in, including where firms deploy AI systems. We also expect firms to be able to show how their systems and controls have been tailored to reflect the nature, scale and complexity of their business models.

Senior management are ultimately responsible and accountable for their firms' activities, including the outcomes arising from the use of automated systems or models. Boards also have an important role to play in providing effective challenge to management. Strong governance which promotes good decision-making and accountability underpins our expectations on firms.

We conducted a review in 2018 through which we observed weaknesses in some firms' governance and oversight frameworks, and compliance and risks monitoring related to algorithmic trading controls. We will conduct follow-up work in this area. This will involve a multi-firm review of firms' compliance with MiFID RTS 6² requirements governing algorithmic trading controls. We will also review selected elements of the MiFID RTS 7³ requirements on trading venues. Where material weaknesses and non-compliance are identified, we will act to ensure risks are mitigated.

2. Financial resilience

Having adequate financial resources allows failing firms to wind down without causing undue harm to the integrity of the UK financial system or to their customers or counterparties. We expect all PTFs to plan ahead and ensure sound management of their financial resources, including having robust plans in place to meet potential demands on both capital and liquidity and to enact an orderly wind-down if necessary.

² https://www.handbook.fca.org.uk/techstandards/MIFID-MIFIR/2017/reg_del_2017_589_oj/?view=chapter

³ https://www.handbook.fca.org.uk/techstandards/MIFID-MIFIR/2017/reg_del_2017_584_oj/?view=chapter

Many firms in the portfolio have limited market exposures and few, if any, customers, so they pose a reduced risk of harm in failure. However, some may have more complex interactions with markets and the real economy. This may be particularly true for those that operate in commodity markets. We expect firms to remain vigilant as to whether their own capital and liquidity risk management arrangements reflect their exposure to the financial and market risks they face and are appropriately aligned to their business model and strategy.

We will undertake targeted reviews of firms' capital and liquidity now that the new Investment Firm Prudential Regime (IFPR) has been introduced. Where we identify material weaknesses in the adequacy of firms' financial resources or planning, we will take action, which may include business restrictions, the imposition of additional own funds and/or liquid assets requirements, or other interventions.

In a number of recent scenarios, when we have engaged with firms that are failing, or in peril, they have considered the cause of their stress to be related to 'unprecedented' or 'unforeseeable' events. In many instances the stress was greater than the severe but plausible scenarios firms had based their modelling on.

Firms should expand the scope of their stress scenarios (including reverse stress test scenarios leading to wind-down) and plan on the basis that their own wind-downs are likely to be made more complex by surrounding stressed environments. These may well affect firms' ability to trade and to realise assets at expected value and may also involve the non-availability of suppliers. It is very likely that the scope of events covered by 'extreme but plausible' is now wider than if exercises were done 18 months ago.

3. Avoiding market disruption arising from commodity market volatility

Our expectations on firms to have appropriate financial resources, as outlined above, apply to all firms in the PTF portfolio. We also have a particular additional focus on commodity trading firms within the portfolio due to recent periods of market volatility. We have seen firms experience credit stress, higher trading costs and capital shortfalls as a result of episodes of market stress in energy, metals and government bond markets. We have also seen examples of ineffective governance contributing to firms' failures to manage their resources effectively. We have conducted enhanced monitoring and engagement with market participants given the risk that stressed market conditions could transmit to the wider financial system.

We will remain agile to new issues and developments and update our approach as needed. Alongside this, we plan to conduct enhanced monitoring and engagement with PTFs which specialise in commodity market trading to identify new and emerging risks and trends within those markets. We consider firms who provide clearing services as well as those firms who hold dominant market positions, to present a higher risk of harm in disorderly failure; this will be reflected in our engagement with those firms. We will monitor firm's capital requirements in light of price movements and ensure firms implement any additional regulatory requirements on them as a result of meeting new regulatory thresholds, to ensure their risk of harm to wider markets is managed.

4. Operational resilience

Technology plays an important role in PTFs' business models, particularly in respect of electronic trading and liquidity provision/market making. The operational resilience of PTFs is therefore critical in ensuring the markets they operate within function well.

The risk of disruption from technology outages and cyber-attacks is an ongoing challenge, as is cyber-enabled fraud. The potential for harm is increased by the complexity of the systems and processes supporting firms' trading activities. Consequently, operational resilience is vital to protecting the integrity of the financial system.

We expect firms that are in scope of our Operational Resilience policy statement⁴ to consider how they will embed the requirements and ensure they operate within their impact tolerances as soon as reasonably practicable, but no later than 31 March 2025. Our rules are designed to strengthen resilience against future incidents, such as the cyber events seen recently, strengthen existing protections and protocols, and improve practices around reconnection and the safeguards around third-party service providers. Firms not formally in scope for these rules should also consider them as good practice.

We will review in-scope firms' implementation plans and expect firms to be able to demonstrate that their approach integrates broader resilience requirements into a coherent overall framework.

5. Brexit impacts

The UK's withdrawal from the European Union has affected firms in the portfolio to varying degrees. Firms who entered the FCA's Temporary Permissions Regime (TPR) at the end of 2020 have had to consider whether their activities in the UK require them to apply for full permissions or not; other firms have also considered whether Brexit has given rise to any restructuring needs or other changes to their business models. We continue to expect firms to inform us at the earliest opportunity if they are considering any changes, including to the movement of any staff, entity, trading desk or function.

We are aware that a number of firms have implemented new structures for the execution and booking of transactions, and their risk management and oversight. These arrangements sometimes involve different entities operating across different jurisdictions and can add new complexity and additional risks. It is important that such arrangements, taken as a whole, enable firms regulated by the FCA to retain sufficient control and oversight of their regulated activities in the UK, and that they can be effectively supervised at all times. We are working closely with HM Treasury to ensure the UK's overseas access regime supports this outcome and firms should consider whether any changes to the regime could impact their business models or structures.

We will engage with firms who are subject to our requirements for the first time as a result of business model or strategy changes arising from Brexit. Those firms should expect us to focus on ensuring their compliance with the key areas outlined above, as well as other elements of the UK regulatory framework, including the Senior Manager and Certification Regime.

Next steps

As CEO, you are responsible for ensuring that relevant staff at your firm understand our rules and principles for businesses and for ensuring that your firm complies with them. Senior Manager Function-holders (SMFs) and other senior management within your firm are also responsible for ensuring their respective areas of oversight and control are fully aware of the FCA's expectations and are compliant and fully resourced.

⁴ <https://www.fca.org.uk/publication/policy/ps21-3-operational-resilience.pdf>

By end-September 2023, we expect all CEOs to have discussed this letter with their fellow directors and/or Board and to have agreed actions and/or next steps.

If you have any questions about this letter, please contact us on 0300 500 0597. This is the primary contact for your firm's day-to-day interactions with the FCA. Further details of how we can be reached are available on our website. However, we recognise there may be occasions when your firm faces urgent issues of strategic importance. In such circumstances, please contact the Manager of the Principal Trading Firms Supervision Team, principaltradingfirms@fca.org.uk

The FCA looks forward to working with you to continue to improve standards and market outcomes for your firm and the wider sector.

Yours faithfully,

Simon Walls - Director, Wholesale Sell-Side