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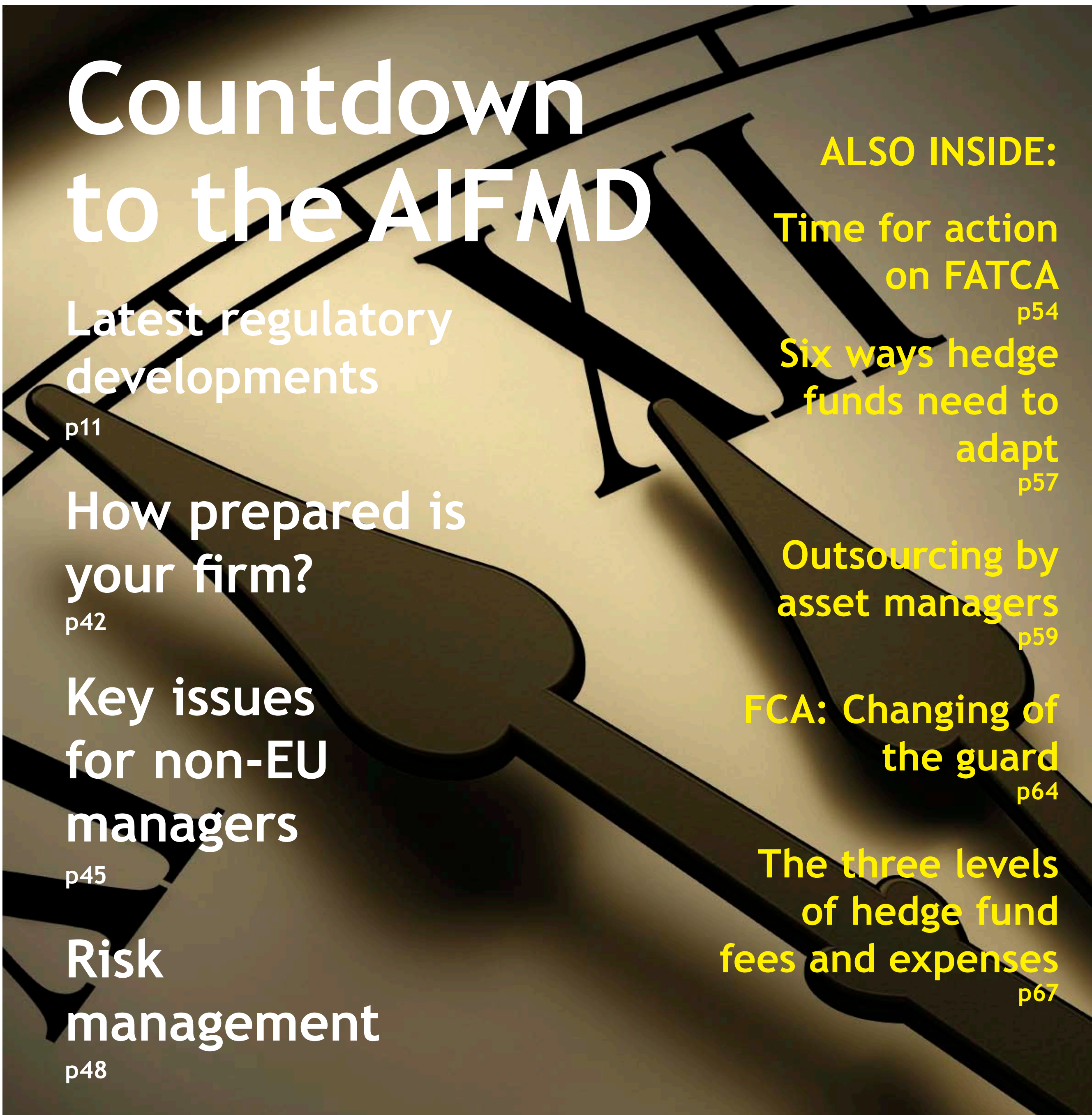

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Changing the guard — what to expect from the UK's FCA

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The 1 April 2013 changeover to the "twin peaks" model of regulation in the UK passed with relatively little publicity. It followed a three-year build-up to the separation of the Financial Services Authority into the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). In the recent raft of approach documents, fact sheets and speeches hailing the dawn of the new regulatory regime, it was easy to overlook subtle messages about the changes that will shape the regulatory landscape for UK wholesale firms in the years to come.

This article looks at a few cultural differences in the supervisory and enforcement approaches of the new regulator for the investment management sector, the FCA.

The new 'consumer'

One of the three operational objectives of the FCA is to secure an appropriate degree of protection for consumers. Recent publications about the FSA's "vision" of how the FCA would accomplish that objective were peppered with references to wholesale conduct and clients. The chief reason for this focus on wholesale is the new definition of "consumer" in the Financial Services Act 2012 which laid the foundation for the new regulatory architecture. Under the new regime, a "consumer" is no longer an individual or a retail client but a "user" of financial services.

This new definition gives the FCA a broader mandate to monitor, and intervene in, wholesale markets and to protect a wider range of client relationships than under the previous regime. The FCA has emphasised that wholesale market participants are entitled to receive a "fair deal" and that it is no longer prepared to accept that it should not be concerned in some categories of relationships because the sophistication of the parties enables them to look after their own interests.[1]

For investment managers, the effects are likely to be two-fold. First, this will mean a greater degree of protection in the marketplace, as in the case of the recent FSA initiative to stop brokers receiving payments for order flow from market makers. Second, there is likely to be further scrutiny of the obligations that investment managers owe to their own clients and investors. In this regard, the handling of conflicts of interest and inducements by investment managers,[2] promotion of collective investment schemes, protection of client assets and charging are likely to be recurring supervisory themes.

Supervision — same but different

The FCA sees itself as a forward-looking regulator. In a move away from a primarily reactive style of supervision, the FCA has abandoned the old approach to supervision (including the ARROW framework) in favour of three pillars: (i) firm systematic framework (consisting of proactive assessments of

1 FCA Business Plan 2013/14 (www.fca.org.uk/news/firms/business-plan-2013-14).

2 See, for example, Conflicts of Interest between Asset Managers and their Customers: Identifying and Mitigating the Risks (www.fsa.gov.uk/static/pubs/other/conflicts-of-interest.pdf).

specific firms or a sample of firms with similar business models); (ii) event-driven work (intervention in emerging issues, for example in response to a report by a whistleblower); and (iii) issues and products (an approach driven by sector risk assessments – similar to the thematic review work that was carried out previously by the FSA).

Firms will be grouped into categories based on the perceived impact metrics associated with the firm's activities and the number of retail clients. Consistent with the pre-FCA supervisory regime, investment managers with no retail clients are likely to be supervised by a team of sector specialists, rather than dedicated supervisors (as "flexible portfolio" firms).

Among the new developments, is the greater supervisory attention to business models, strategy and governance. In this regard, the FCA has promised to encourage its staff to be more confident in making bold decisions and to ask probing questions to develop a better understanding of a firm's motivations.[3] This new proposition is likely to have the most immediate effect on how the FCA reviews applications for authorisation of new entrants but will also mean that authorised firms should be prepared to share more information about their businesses, future plans and decision-making processes as part of their ongoing relationship with the FCA.

"Flexible portfolio" firms should not expect routine inspections from the FCA but will be assessed on a four-year cycle (with a possibility of interim reviews where the data available to the FCA indicates that the risk represented by the firm is changing). As under the old regime, investment managers are more likely to be contacted by the regulator as part of thematic reviews aimed at identifying emerging risks and good and bad practices within the relevant sector.

Senior management responsibility

Amongst the key aspects of the new supervisory approach is the focus on the individual responsibility of the senior management for the compliance culture, business planning, risk-taking and incentive structures within the firm — a theme that was central to the "treating customers fairly" initiative undertaken by the FSA in recent years.

This will mean attention to specific instances of misconduct (or inaction) by the senior management and holding senior managers, including compliance officers, accountable for breaches through enforcement actions. Recent enforcement cases[4] show that firms that currently do not have an independent compliance function should think carefully about how this function should be allocated. The expectation is that the individual holding the compliance oversight function should have both the authority (that is, be among the most senior managers) and the skills to challenge business decisions in a timely and effective manner.

'Credible deterrence' carries on

The "credible deterrence" ethos will be carried forward by the FCA, as it builds on the past enforcement successes of the FSA. The FCA is committed to bringing even more enforcement cases than its predecessor and making examples of firms and individuals in an effort to deter others from offending

3 Journey to the FCA (www.fsa.gov.uk/static/pubs/other/journey-to-the-fca-standard.pdf).

4 See, for example, the FSA's enforcement case against Alexander Ten-Holter (www.fsa.gov.uk/static/pubs/final/ten-holter-greenlight.pdf).

or failing to meet the standards of conduct and organisation of the business and risk management systems expected of them. The new regulator's ambition is to continue looking "further up the chain of command"[5] at those senior managers who fail to recognise and manage the risks within the firm appropriately. The FCA is likely to carry on pressing for tough penalties, large fines and individual prohibition orders.

One of the key procedural changes is the new FCA power to announce that it intends to take a disciplinary action against a firm or individual by publishing a "warning notice". Needless to say, the possibility of such publicity before the firm or individual targeted by the FCA has had the opportunity to respond is alarming. The FCA is required to consult with the subject of the enforcement action before publicising the warning notice, but is not required to obtain the subject's consent.

A warning notice may not be published if it is unfair to the person against whom the action is proposed. However, the FCA is unlikely to consider the mere risk of reputational damage as sufficient grounds for not using its early publicity powers.

Conclusion

Investment managers should approach the changeover to the new regulator as an opportunity to scrutinise their existing governance, business planning and compliance arrangements. Firms should consider what procedures may need to be put in place (or reviewed) to prepare for a different relationship with their regulator, focusing their attention on the areas that have been continuously highlighted as regulatory priorities over the past year, including decision-making processes, senior management involvement in compliance, and conflicts of interest.

Investment managers should also examine their arrangements for investor disclosures (such as the early engagement with investors in the case of regulatory investigations) and, of course, remember to update their stationery with "authorised and regulated by the Financial Conduct Authority".

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5 Credible deterrence: here to stay. Speech by Tracey McDermott at the FSA's Enforcement Conference 2012 (www.fsa.gov.uk/library/communication/speeches/2012/0702-tm.shtml).