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Client Alert

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United Kingdom: Treasury and FCA propose stronger oversight of appointed representatives

In brief

The FCA has published a consultation (CP21/34) proposing changes to the Appointed Representatives (AR) regime. In parallel, HM Treasury (HMT) has published a Call for Evidence on possible legislative reforms to the AR regime.

These papers present significant, wide-ranging changes that have the potential to seriously impact the way that AR arrangements operate, and the burdens placed on principals in particular. We explore the proposals in more detail below.

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The FCA's consultation

The FCA is seeing a wide range of harm across all the sectors where firms use AR arrangements. This harm often occurs because principals don't perform enough due diligence before appointing an AR, or from inadequate oversight and control after an AR has been appointed. Interestingly, the FCA notes that, on average, principals cause 50 to 400% more supervisory cases than non-principals, and that cases are higher than for non-principals across every sector.

The FCA's previous thematic reviews of the general insurance sector in 2016 and the investment management sector in 2019 identified significant shortcomings in principals' understanding of their regulatory responsibilities for their ARs. Failings included insufficient oversight of their ARs and inadequate controls over the regulated activities for which they had accepted responsibility. Since the FCA published these reviews, there have been further examples of failings through the FCA's supervisory and enforcement work in the retail and wholesale markets sectors where this model also operates. The FCA took steps to address issues at individual firms following each of the thematic reviews, including a recently concluded Enforcement case relating to a firm's oversight of its ARs (Alsford Page & Gems Limited, April 2021). Other communications include a number of Dear CEO letters as well as thematic findings.

Further, The Treasury Select Committee has recently recommended that the FCA and HMT consider reforms to the AR regime, with the aim of limiting its scope and reducing opportunities for abuse of the system. The FCA is working with HMT to explore whether legislative changes to the regime are also required, as explored further in HMT's Call for Evidence.

In response, the FCA is proposing changes which:

- require principals to provide additional and more timely information on their ARs and how these are overseen, and
- clarify and strengthen the responsibilities and expectations of principals.

Notably, the FCA does not propose to apply the amended rules to overseas firms, or firms in the Temporary Permissions Regime (TPR) or Financial Services Contracts Regime (FSCR). While there may be some firms which entered the TPR and then may have since taken on ARs, given the limited time period during which such firms are able to operate under TPR, the FCA considers that these firms will have become directly authorized (or otherwise recognised in the UK financial services market) by the time the rules would take effect.

Information and notification requirements

The FCA proposes to require principals to:

- provide more information on their ARs and the business these ARs conduct (for example, on revenue, non-regulated business, financial arrangements between the principal and AR, whether any individuals from the AR will be seconded or contracted to the principal firm to carry on portfolio management or dealing activities, and complaints);
- notify the FCA ahead of any significant changes they are planning in relation to ARs before these changes are made;
- report to the FCA, for inclusion in the FS Register, specific information on the activities the ARs are permitted to undertake; and
- notify the FCA of an intention to begin providing regulatory hosting services before beginning to do so (the FCA is also seeking feedback separately on regulatory hosting arrangements themselves – see *Regulatory hosting arrangements and other risky business models* below).

Currently, principals only provide the FCA with high-level information on the market in which the AR operates. The FCA proposes to require principals to provide additional details on the business each of their ARs will conduct when an AR is appointed and on an ongoing basis, including when these details change over time.

The FCA proposes to require notification of these additional items of information in respect of existing ARs as well as those appointed after the proposed rules come into force. Going forward, the FCA proposes to require that a principal notifies the regulator of a proposed AR appointment at least 60 calendar days before the appointment takes effect. Principals will also be required to report planned significant changes at least 10 calendar days before the change takes effect, and to verify the accuracy of their AR details annually.

Clarifying expectations of principals

The FCA's proposals include a number of new requirements clarifying or enhancing the oversight responsibilities of principals.

Clarifying principals' responsibilities:

- Principals, where they delegate functions or tasks to an AR or tied agent, should put appropriate safeguards in place. Principals should ensure that delegated functions or tasks do not represent a conflict of interests and are subject to enhanced monitoring. The FCA proposes to extend to all principals the existing guidance in SYSC 3.2.3G(1) on how certain firms should ensure appropriate safeguards are put in place where certain functions or tasks are delegated.
- Principals must assess senior management at ARs for competence and capability. Principals should consider the FCA's proposed guidance on how practically to assess senior management at ARs, including ensuring and verifying accuracy of information provided by ARs, discussing omissions or concerns proactively, and keeping up to date with changes.
- Principals must ensure their ARs act within the scope of their appointment. Currently, under SUP 12.6.6R, principals must take "reasonable steps" to ensure that ARs act within the scope of their appointment. The FCA proposes to issue guidance on what it considers "reasonable steps" to be – including (among others) collecting and scrutinizing management information, analysing AR data to identify emerging risks, and closely monitoring delivery of AR's activities through, for example, reviewing call scripts and organising regular meetings. This guidance is important, because breach of the rules in SUP 12 may be actionable under section 138D of the Financial Services and Markets Act 2000 (FSMA) by private persons who suffer loss as a result of the breach (see SUP Sch 5). This proposal is intended to ensure firms understand how they can take practical, reasonable steps to ensure that their ARs do not undertake unlawful regulated activity.

Overseeing ARs effectively:

- Principals must ensure controls and resources are adequate. Principals should annually review the adequacy of controls and resources in line with the FCA's proposed guidance of what these could look like: controls and resources which (i) are commensurate to the size of the AR's business and the regulated activities it carries on, (ii) enable the principal to effectively manage conflicts of interest, (iii) allow the principal to maintain effective oversight of the AR, and (iv) enable the principal to identify and resolve any issues arising from the AR. Where controls and resources are inadequate, principals should consider a Principle 11 notification. If the issue cannot be resolved, the principal should postpone appointment of the prospective AR or otherwise terminate the existing AR relationship.

- Principals must complete an "oversight appropriateness" review. This is to determine whether the resources and systems and controls the principal uses to monitor the AR's activities and business are appropriate. Principals should consider the FCA's proposed guidance on the circumstances in which this review would be triggered (such as a significant increase in the size/volume of the AR's regulated business in a short period of time, or unusually high senior management or staff turnover). Principals should also review the contractual relationship with an AR where it, or its business, grows rapidly in a short time.
- Principals must have systems and controls in place which anticipate the oversight of ARs to a comparable standard as if they were an individual directly employed by the principal and the activities being undertaken by the AR were in-house at the principal. Principals should consider the FCA's proposed practical expectations of how they might achieve this standard of oversight through systems and controls (see the proposed practical guidance on "reasonable steps" above).
- Principals must ensure, when appointing an AR and on ongoing basis while in a contractual arrangement with an AR, that the activities the AR carries on do not, or would not, result in an undue risk of harm to consumers or market integrity. Principals should meet proposed expectations of how they might identify harm; considerations include:
    - customer impact if a harm were to crystallise;
    - financial loss to customers;
    - risks to the principal;
    - substitutability of the AR's services;
    - potential for reputational damage;
    - concerns about the AR's business model or governance arrangements; and
    - the ability of the principal's arrangements to effectively identify and manage risks.
- Principals must annually review fitness and propriety of senior management at ARs and the ability of relevant persons at the AR to carry out regulated activities for which the firm has accepted responsibility. This review will need to be carried out more regularly in certain circumstances.
- Principals must arrange ongoing oversight of their ARs. Principals should consider the FCA's proposed practical guidance on how to achieve this.

Termination of AR contracts and winding down:

- Principals must have clarity on the circumstances in which they should terminate an AR relationship. Principals should consider the FCA's proposed guidance on circumstances and terminate relationships if necessary; circumstances include (among others):
    - issues with the AR that are not satisfactorily or reasonably resolved;
    - high AR senior management turnover without satisfactory explanation;
    - where the AR is carrying on regulated activities outside the scope of its appointment;
    - where the AR has intentionally misled customers; or
    - where any of the AR's senior management involved in carrying out activities for the principal have been dismissed for gross misconduct.
- Principals must ensure, when terminating a relationship with an AR, that they do this in an orderly way. Principals need to assist ARs with orderly wind down where they decide this is necessary.

Self-assessment:

- Principals must annually prepare a self-assessment document demonstrating their compliance with aspects of the policy and methodologies used to complete the assessment. If requested, principals would need to submit the self-assessment document to their FCA supervisor.

Regulatory hosting arrangements and other risky business models

Outside of specific proposed rule changes, the FCA is also seeking views on a number of issues relating to risky business models.

Regulatory hosting models commonly take on a form where, rather than carrying on any substantive element of a regulated activity itself, the principal oversees the use of its permissions by ARs. This service is commonly marketed as an additional service alongside other compliance support services, and offered as an alternative to applying for authorisation. The FCA has seen an increase in the use of these services recently, including notably in the investment management sector, where staff seconded from the AR to the principal to undertake managing activities then often lead to the AR marketing its "investment management" services. This gives the impression that the AR can carry on a wider range of regulated activities than those for which the principal can lawfully accept responsibility. The "Host AIFM" model is an example of this arrangement: under this model, a principal is appointed as the alternative investment fund manager (AIFM) to an alternative investment fund (AIF), and the AR is usually appointed as an adviser to the AIF. Staff from the AR may be seconded to the AIFM and, in this capacity, they can undertake portfolio management. Under this arrangement, the AR, rather than the principal as AIFM, claims to be the fund manager when marketing AIFs, when legally this role is taken by the principal.

There is currently no definition of "regulatory hosting" in the FCA Handbook. The FCA has proposed a new definition in the consultation based on these typical characteristics, to align with the proposal noted above to require firms to notify the FCA of their intention to begin providing regulatory hosting service before they begin to do so. Under the proposed definition, a "*regulatory host*" is a firm:

(1) *that offers or provides a service by which unauthorised persons, whether or not closely linked to the firm, may become appointed representatives of the firm;*

(2) *that markets or offers the service in (1) to unauthorised persons as an alternative to applying for authorisation;*

(3) *that provides the service in (1) for remuneration with a view to profit; and*

(4) *to which either (a) or (b) applies:*

  (a) *the firm does not carry on any regulated activities in a principal capacity; or*

  (b) *the regulated activities carried on by one or more appointed representatives of the firm are not connected to any regulated activity undertaken by the firm in a principal capacity.*

The FCA is seeking views on this definition, given that it may affect the application of the FCA's proposed rule changes (as explained above).

Further, the FCA is also seeking feedback on how to address the harm arising from business models which may result in inadequate oversight arrangements and/or conflicts of interest. This is the case particularly where principals employ regulatory hosting arrangements, where ARs are large in size relative to the principal, or where principals have appointed overseas ARs (potentially in order to enable the AR to access UK markets by circumventing authorisation requirements). The FCA is seeking views as to potential policy options for reducing the risk of harm from these business models, including:

- banning the use of regulatory hosting services by prohibiting the engagement of ARs which operate businesses which are materially distinct from that of the principal;
- limiting the maximum size of ARs before requiring them to become fully authorised in their own right;
- requiring the specific consent of the FCA to provide regulatory hosting services or to have larger ARs than the principal;
- limiting the range or scope of regulated activities that regulatory hosts can oversee and/or the number of ARs they can have, in order to regulatory hosts focus on specific areas, sectors and products;
- requiring principals that provide regulatory hosting services and firms with larger ARs to meet additional requirements to those that apply to other principals, for example particular staff ratios or higher capital requirements;
- relying on changes already proposed in the consultation, including requiring firms that want to provide regulatory hosting services to notify the FCA of this intention before beginning to provide these services; and/or
- requiring principals to regularly review the relative size/scale of business carried on by their ARs and consider whether it remains appropriate.

Finally, the FCA is interested in views on which sectors or business model arrangements that involve ARs could benefit from new or enhanced prudential standards, to reflect the harm posed to consumers and markets.

HMT's Call for Evidence

HMT's Call for Evidence, issued in parallel with the FCA's consultation paper, seeks views on areas of reform to the AR regime which will require legislative amendments. These include:

- The **overall scope of the exemption for ARs** (under section 39 FSMA) from the general prohibition from carrying on regulated activities, including the regulated activities which ARs are permitted to carry on. Here, HMT appears reluctant to prohibit ARs from carrying on particular regulated activities or restricting activities to less risky products or business models, given that the FCA has identified that complaints against ARs are more prevalent in the wholesale markets and there is not yet strong evidence of unacceptable risk of harm to consumers or market integrity. HMT suggests that potential reforms include altering the scope of the section 39 exemption by specifying new conditions which would need to be met in order for the exemption to apply, such as a size limit for ARs, or requiring the principal to be carrying on the same regulated activities as its ARs.
- The **regulatory tools available to the FCA**, should it be concluded that the FCA should be empowered to do more to prevent abuse of the AR regime. This could be addressed by introducing a more formal "principal permission" gateway, whereby authorised firms must gain a specific permission from the FCA before appointing ARs – similar to the financial promotions gateway soon to be introduced for firms (although there are certain exemptions from that gateway for principals – for more on the forthcoming financial promotions gateway, see our previous alert here). Further, the information gathering and investigation powers of the FCA set out in Part XI of FSMA could be extended to apply directly to ARs, though there is a recognised risk that this could undermine the purpose of the regime that the principal rather than the AR is authorised and regulated by the FCA, and the principal that assumes responsibility for the regulated activities carried on by their ARs.
- Whether more **direct regulatory requirements** should be placed on ARs in order to strengthen incentives for regulatory compliance and high standards of conduct. Here, HMT is considering extending the Senior Managers and Certification Regime requirements in some form to cover ARs, for example by applying rules of conduct to AR staff. However, there are challenges in this approach, including blurring the lines of responsibility as well as the boundaries between the AR regime and full authorisation by imposing more direct regulation.
- The **role of the Financial Ombudsman Service (FOS)** in relation to ARs and their principals where consumers have experienced detriment whilst dealing with an AR. If an AR is undertaking regulated activities that are outside the scope of the AR's agreement with its principal, consumers may find that the FOS is unable to investigate their complaint. This can include circumstances where there has been a technical failure to appoint an AR correctly, for example where the agreement between AR and principal does not contain one of the prescribed requirements. HMT suggests that the section 39 exemption could be amended so that a principal is responsible for all of an AR's regulated activities, even if the appointment is invalid.

The Call for Evidence also asks for views on how appropriate and effective the current regulatory approach is at ensuring the safe operation of a number of different AR models, including Introducer ARs, salespeople and smaller ARs, larger/complex ARs, and regulatory hosting.

Impact on firms

Responses to both papers are due by 3 March 2022. The FCA is expected to issue final rules in the first half of 2022; transitional periods are expected to apply for certain proposed rules, including for example the provision of revenue data by existing ARs and the inclusion of termination provisions in existing principal-AR contracts. HMT has not set out an expected date for feedback and final policy.

It is clear that the FCA's proposed changes to reporting details, notification requirements and oversight responsibilities will impose a potentially significant burden on firms in terms of time and resources: looking purely at costs, the FCA estimates that average one-off costs per principal firm are expected to be £6.4k – but for principals overseeing 100 or more ARs, this could rise to £54.3k. To prepare for the proposed new requirements, it is likely that firms will need to:

- review and change their internal processes, for example to ensure that senior management and boards take responsibility for signing off firms' self-assessment documents, to establish procedures for collecting and scrutinising entry-level and management information from ARs, and to put in place service level agreements where necessary;
- assess their organisational structure or recruitment to ensure they have appropriately experienced and trained staff responsible for AR oversight;

- undertake compliance familiarisation and gap analysis work, as well as staff training on the new requirements; and
- review and change internal IT systems to meet the proposed reporting and notification requirements.

The FCA has invited stakeholders to provide views on how the regulator could help firms manage the reporting and notifications burden..

There may also be a significant impact on the volume of new entrants to the market – these changes are designed to make the AR regime more burdensome from a compliance perspective, and a consequence of that may be increased barriers to entry for market participants considering the AR regime as a viable business model. As set out in the its 2021/22 Business Plan and 2020/21 Perimeter Report, the FCA is already intensifying scrutiny for all principals seeking permissions at the authorisation gateway – the FCA notes in its cost benefit analysis that in a small pilot of a more enhanced approach, 65% of new principals have either withdrawn or the FCA has been minded to refuse their applications. Should HMT proceed with a new "principal permission" gateway, these barriers to entry will increase further.

It is also clear that both the FCA and HMT have reservations about the proliferation of the regulatory hosting model, key in sectors which more heavily rely on the “regulatory umbrella” model – for example, asset management such as "Host AIFM" arrangements (as explained above), investment advisors, corporate finance advisory firms and certain businesses in the consumer credit space. HMT and the FCA express concerns about sufficient oversight expertise in principal firms which do not themselves directly carry on the regulated activities of the ARs for which they are responsible, and the resource challenges – and potential conflicts of interest – posed by the principal business model's reliance on a large number of ARs being able to use the principal’s regulatory permissions in order to be profitable. These reservations are borne out directly in the FCA's proposal to require principals to notify the regulator of an intention to begin providing regulatory hosting services, which will not only allow the FCA to check on due diligence and oversight arrangements and to voice concerns, but more importantly will give the FCA an opportunity to understand just how widespread the business model is – the FCA itself admits that there are likely many more principals offering these services than it currently knows of. The FCA is also seeking feedback on potential harms arising from the use of the regulatory hosting model in the investment management sector, including specifically the Host AIFM model. Firms using these arrangements should prepare themselves for the possibility that HMT and the FCA will seek to exert further supervisory oversight of regulatory hosting arrangements, including potential restrictions or limitations on the use of the model.

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