FCA Outlines Plans That Could Reshape Regulation of Asset Managers in the UK

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The UK financial services regulator, the Financial Conduct Authority's latest three-year Strategy and annual Business Plan could have a significant impact on private capital sponsors and advisers and other asset managers.

The documents, released April 7, 2022,[1] set out the FCA's ambitions for 2022 to 2025, comprising 13 commitments to specific regulatory activity across three key strategic areas: reducing and preventing serious harm; setting and testing higher standards; and promoting competition and positive change.

The FCA also set out four overarching outcomes expected of firms: (1) fair value, (2) confidence, (3) access, each of which apply to both the wholesale and retail sectors, and (4) suitability and treatment, which applies to retail only.

The Business Plan sets out the FCA's plan of activities over the next 12 months to help deliver on these commitments and how it will measure progress. It marks a shift to a greater focus on outcomes-based regulation rather than on process. It also marks a change from previous business plans, which were organised by sector, instead applying the commitments on a broader, cross-sector basis, grouped by focus areas.

Key Points for Asset Managers

The areas most crucial for asset managers are the FCA's commitment to:

- improve oversight of appointed representatives;
- reform the financial promotions regime; and
- improve the FCA's environmental, social and governance (ESG) priorities.

Improving Oversight of Appointed Representatives (ARs)

ARs are persons who carry out regulated activity under the responsibility of an authorised firm (their principal), who is responsible for ensuring the AR is fit and proper and complies with relevant rules.

Such arrangements are used in the asset management sector, often as a means for new market participants, such as newly-established investment advisers, to carry out regulated business without incurring the cost and complexity of obtaining direct FCA authorisation. This includes 'regulatory hosting' models, where the principal does not itself carry on any substantive regulated activity, but acts solely as a host for ARs to use its permissions (a service commonly offered by compliance support businesses).

The increasingly burdensome regulation of asset managers combined with the reduced market access for British firms as a result of Brexit have made AR arrangements popular, particularly for private fund sponsors and advisers.

The Strategy notes that activities carried out through ARs generate more complaints than those undertaken directly by authorised firms and ARs are thought to present a greater risk of consumer harm. To address this, the FCA seeks to enhance principals' oversight of their ARs. In particular, the FCA intends to:

- strengthen scrutiny at the regulatory gateway by engaging more with principals as they appoint ARs and carrying out robust assessments of authorisation applications by prospective principal firms.

[1] "Our Strategy 2022 to 2025" and "Business Plan 2022/23"

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- publish final rules on the AR regime following the consultation begun in December 2021 (CP21/34).[2] The consultation includes proposals to clarify and strengthen principals' responsibilities and the FCA's expectations of them and increase the amount and timeliness of information the FCA receives on principals and their ARs, and the details of ARs included on the FCA register.
- assess the need for further policy changes regarding regulatory hosting as raised for discussion in the above consultation. Regulatory hosts have been found by the FCA to apply less effective oversight of their ARs. Potential policy options include prohibiting the model outright, requiring specific FCA consent for hosting and limiting the scope of activities that principals may oversee.
- intensify supervision of principals to reduce the most significant risks of ARs, including increasing the FCA's use of data to better target interventions.
- undertake more assertive supervision of high-risk principals, including greater use of regulatory tools and appropriate enforcement action.

The FCA and the UK Treasury have coordinated in assessing possible changes to the broader AR framework, and the Treasury published a Call for Evidence in December 2022.[3] This proposed changes to the overall scope of activities that may be carried out by ARs, augmenting the tools available to the FCA to prevent abuse of the regime and placing more direct requirements on ARs, in contrast to the current indirect imposition of requirements via principals.

Asset managers using AR arrangements, or considering their use, should be mindful that these models, and particularly principals' arrangements for overseeing their ARs, will be under greater scrutiny going forward — both by means of enhanced rules and, in practice, via intensified FCA supervision — and ensure that their arrangements are robust in this regard. Those making use of regulatory hosting services, in particular, should monitor the outcome of the discussion on this topic over the course of the year and ensure they are prepared for any new restrictions.

Although the FCA's focus has partly been on consumer harm, the proposed new rules are not restricted to ARs engaging with retail investors, and apply equally to those operating in the wholesale sector. Over a longer timeframe, more fundamental changes to the scope and nature of arrangements may be implemented, subject to the outcome of the Treasury's legislative proposals, which asset managers should also continue to monitor.

For many, particularly in the private fund sector, the AR regime has provided a helpful, albeit temporary, gateway to full FCA authorisation, but it is not clear how long this will remain viable.

Reforms to the Financial Promotions Regime

A number of reforms are proposed to the UK financial services marketing (or "financial promotions") regime to tackle the mis-selling of products. Notably, this includes a focus on reducing the mis-selling of high-risk non-standard investments to consumers that do not align with their risk tolerance. This will be particularly relevant to managers and distributors of high-risk products in the private funds sector, such as unauthorised funds.

The proposals include:

- requiring authorised firms to obtain specific permission to approve financial promotions on behalf of unauthorised persons (the 'financial promotions gateway'), in contrast with the current position, where all authorised firms are able to approve financial promotions. This is subject to legislative change to be carried out by the Treasury but forms a key part of the FCA's intentions in this area.
- publishing final rules following its consultation regarding financial promotion rules for high risk investments, including crypto assets (CP22/2[4]). This includes proposals to:
  - rationalise the currently complex classifications of high-risk investments (including the 'Non-Mainstream Pooled Investment' definition that seeks to capture pooled investments in an unauthorised fund);
  - strengthen the 'consumer journey' into high-risk investments (ensuring more engagement by consumers with risk warnings, rather than simply 'clicking through'); and
  - strengthen the role of firms approving and communicating financial promotions via complementary rules to the proposed financial promotion 21 gateway (*e.g.,* ensuring they have the relevant expertise in the promotions they approve).
- Increasing FCA resources for recognising non-compliant promotions, including via analytics.

The FCA is clearly cognisant of the increased 'retailisation' of the private capital market and these proposals reflect that. Asset managers should monitor these developments, and ensure, in particular, that they understand any changes to the classification of the products they market in the UK and are in a position to comply with the new rules regarding products within the scope of the regulations, particularly asset managers currently marketing

[2] FCA, "Improving the Appointed Representatives Regime" (consultation paper) (December 2021)

[3] UK Treasury, "The Appointed Representatives Regime: Call for Evidence"

[4] FCA, "Strengthening Our Financial Promotion Rules for High Risk Investments, Including Cryptoassets" (consultation paper) (January 2020)

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products that qualify as high-risk investments. This is likely to become even more pertinent as the line between retail and professional client becomes increasingly blurred as wealthy individuals seek to access the private market.

In addition, should the financial promotion gateway be implemented, firms that approve promotions on behalf of others seeking to market funds in the UK (including for example, for other non-UK-authorised group entities) will in due course need to consider whether to apply for permission to approve promotions or seek alternative means (*e.g.*, engaging a third party firm to do so).

ESG

The FCA notes that the financial sector has an important role to play in helping the transition to a net zero economy and a more sustainable long-term future. It therefore intends to embed its ESG work across its organisation to support the financial sector in driving positive change in these areas.

The FCA set out its ESG strategy already in November 2021,[5] including target outcomes and actions to deliver them. Key regulatory activity goals for the year are to:

- embed consideration of ESG issues in the authorisation process, considering factors such as diversity and inclusion, the nature of the firm and the products/services it wants to offer.
- build on the UK regulatory framework for ESG, including:
  - actively monitoring the implementation of disclosures by firms and listed companies. This includes, notably, the implementation of new client-facing climate disclosures for FCA-regulated asset managers, including UK-authorised Alternative Investment Fund Managers (AIFMs), as proposed in its consultation last year.[6] The FCA plans to publish final rules by the end of 2022. It also intends to consult this year on the introduction of ESG disclosures for investment firms as part of the new investment firms prudential regime;
  - leading the ongoing development of a labelling regime for investment products and an effective ESG ecosystem to support integrity in the market for ESG-labelled securities;
  - driving improvements in outcomes through diversity and inclusion transparency, and consulting on this in summer 2022; and
  - strengthening investor stewardship.
- monitor firms to see how they manage the impacts, risks and opportunities of ESG issues, including how they ensure customers are treated fairly, and take enforcement action as needed.
- embed ESG across the FCA organisation so that more staff are empowered to intervene swiftly where firm practices do not meet its expectations (*e.g.,* greenwashing).

ESG has been a high priority on the regulatory agenda for the asset management sector across the globe in recent years and will therefore already form a significant part of the compliance workload for market participants. But asset managers with FCA-regulated asset management entities or investment firms in their group will need to be particularly mindful of the FCA's ESG initiatives for the year, including any new disclosure requirements.

[5] FCA, "A Strategy for Positive Change: Our ESG priorities" (December 2021)

[6] FCA, "Enhancing Climate-Related Disclosures by Asset Managers, Life Insurers and FCA-regulated Pension Providers" (December 2021)