Strengthened FCA Rules for Appointed Representatives: Implications for UK Financial Firms

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If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Greg Norman
Partner / London
44.20.7519.7192
greg.p.norman@skadden.com

Azad Ali
Of Counsel / London
44.20.7519.7034
azad.ali@skadden.com

One Manhattan West
New York, NY 10001
212.735.3000

40 Bank Street
Canary Wharf
London, E14 5DS
44.20.7519.7000

The U.K. Financial Conduct Authority (FCA) recently introduced important changes to the regime governing Appointed Representatives (ARs), which carry out regulated activity for which an authorised firm is responsible. The new rules are a response to the perception that ARs have not been adequately regulated and that this creates a risk of harm to consumers. They clarify and enhance principals' responsibilities for ARs.

These changes will come into effect on 8 December 2022, and will require authorised firms acting as principals to overhaul their existing and proposed arrangements with ARs. In addition, shortly after the new rules take effect, principals will also be required to provide detailed information about existing AR arrangements — something that principals should prepare for ahead.

The amendments to the AR regulations were set out by the FCA in a policy statement published in August 2022, which followed a consultation paper in December 2021.

Background

The Financial Services and Markets Act 2000 (FSMA) prohibits firms from carrying out activities that are regulated in the U.K.'s financial services sector unless they are authorised by the FCA or exempt. The AR regime provides an exemption to unauthorised firms (the ARs) if they are appointed by an authorised firm (the principal) and regulatory responsibility for the activities of the AR is assumed by the principal. Accordingly, ARs are able to carry out certain activities that are regulated in the U.K.'s financial sector without requiring their own authorisation from the FCA. Principals must accept responsibility over the activities carried out by their ARs, and are required to monitor compliance with FCA regulations on their behalf.

Conducting regulated activities as an AR reduces the costs, risks and burdens associated with regulatory compliance, such as capital and liquidity requirements and maintaining prescribed levels of governance and internal control functions. AR appointments are common in retail financial services, particularly among financial advisors, insurance brokers and mortgage intermediaries; asset management, allowing sub-advisors to operate without direct FCA authorisation; M&A advisory firms; and other areas. Firms often rely on the AR regime as an interim solution to enable them to commence business whilst in parallel seeking authorisation.

The AR regime has come under scrutiny by the FCA and the U.K. Treasury simultaneously. As the regime originates in primary legislation, (*i.e.*, the FSMA), it falls to the Treasury to consider any changes to the fundamental design and scope of the regime. The FCA is responsible for developing rules to govern how the AR regime operates and is managed in practice, and its rulemaking power is limited by the parameters sets out in the FSMA. The Treasury's work here is based on a Call for Evidence published in December 2021, the outcome of which is expected to be published in 2023. The Treasury's evaluation of the current legislative framework for ARs will be influenced by the effects of the FCA's revised rules.

Issues With Current AR Regime

The AR regime was initially designed to promote market access for smaller firms, to increase customers' choice with respect to financial services providers and to foster competition in the financial services industry. However, the design of the regime made it inherently prone to misuse and inconsistency in the regulatory compliance standards

employed by principals. Inevitably, the regime came under regulatory scrutiny largely in response to cases where there were clear instances of customer and market harm.

The perceived shortcomings of the AR regime were broadly twofold. First, the FCA found that principals often conducted insufficient due diligence on newly appointed ARs, and they often lacked a clear understanding of their regulatory accountability. Principals were also caught with inadequate systems of control in place to monitor the activities carried out by ARs in the financial services industry. Increased levels of information reporting between ARs and principals and between principals and the FCA were suggested as the most effective solution to address widespread instances of inadequate oversight by principals.

Second, the FCA identified certain dishonest practices by ARs where the FCA had little regulatory control because of the lack of supervision by principals over their ARs. Many instances were identified of ARs providing misleading information to consumers, offering products and services that were inadequate for the profile of their customers, or engaging in practices that prevented consumers from having access to appropriate redress. For instance, in cases where ARs carried out regulated activities outside the scope of their agreements with principals, consumers were unable to hold principals liable for them. In terms of gauging the overall levels of harm to customers, there have been a disproportionate number of supervisory cases against principals compared to those against firms that did not act as principals.

Key Changes

Notification Requirements

Under the new rules, principals are required to make a notification to the FCA 30 calendar days before appointing a new AR. For existing AR appointments, principals will have to submit a separate notification within 60 days of receiving a data request from the FCA. The FCA expects to deliver data requests to all existing principals in December 2022. Those will seek the primary reasons for appointment of each AR, the nature of the regulated activities ARs are permitted to undertake, and whether services to retail clients will be provided by ARs during the course of their engagement. Principals must also disclose details of ARs' previous appointments, describe any non-regulated financial activity carried out by the ARs, and provide a calculation of the ARs' expected revenue from regulated and non-regulated activities for the year ahead.

The notification triggered by the FCA's data request will be a one-off exercise for principals with ongoing AR appointments and is intended to give the FCA more detailed information about existing appointments. Principals are advised to prepare the relevant information in advance of receiving the FCA data request. Principals with ten or more AR appointments will be able to complete a single data request form for all their ARs, rather than needing to fill in a form for each AR individually. This measure has been designed to reduce the burden of disclosure significantly.

In addition, principals will also be required to provide the FCA with complaints data and revenue information regarding their ARs annually, within 60 days after the principal's accounting reference date. Any changes in an AR's details or if the nature of the appointment changes (including the scope of the activities carried out by ARs), will have to be notified to the FCA at least 10 calendar days before the changes take effect.

Regulatory Hosting

Regulatory hosting refers to the business model of authorised firms whose exclusive activity is the provision of services as a principal to ARs in return for a fee. Firms acting as regulatory hosts to others wishing to use their FCA authorisation will also be required to notify the FCA at least 60 calendar days before providing these services. Principals will be able to do so under the December 2022 data request, rather than having to submit a separate notification in relation to regulatory hosting. There are no additional requirements for firms currently providing regulatory hosting services although the FCA acknowledges that this business model could warrant further regulatory attention in the future.

Responsibilities of Principals and FCA's Expectations

The FCA expects principals to carry out appropriate due diligence before an AR is appointed, and after establishing processes and systems suitable for monitoring ARs so the principal can identify issues that might cause consumer or market harm.

In particular, principals will need to ensure that the activities delegated to ARs do not pose any conflict of interest, and that enhanced monitoring mechanisms over ARs are put in place, especially with regard to assessing senior management of the ARs. These systems and controls should be designed to a standard comparable to that for individuals employed directly by the principal.

In practice, principals will be required to conduct an annual review of the activities, management and overall financial position of their ARs. The review can be integrated by principals in their existing internal reporting process, and must be conducted by individuals with a suitable degree of knowledge and authority within the principal's firm, but not necessarily the board of directors (or equivalent governing body).

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Alongside the annual review, principals are required to undertake an annual self-assessment exercise that describes how they are meeting their responsibilities in relation to ARs as a whole, and which considers the adequacy of the resources allocated for the purposes of AR monitoring. The results of the self-assessment must be set out in a single document that must be signed off by the principal's board of directors. Principals will not need to create a new document each year, but will be able to review and update the existing self-assessment document prior to seeking board approval.

Importantly, the requirement for self-assessment is subject to a transitional implementation period. Whilst principals may start preparing the self-assessment document immediately, approval from the board may be sought up to 8 December 2023, one year after the new rules are implemented. The self-assessment document does not need to be filed with the FCA, but must be made available upon the FCA's request.

Altogether, these changes are intended to clarify and improve a principal's understanding of its responsibilities and to strengthen its oversight over ARs.

Next Steps

Moving forward, the FCA will monitor the implementation of the new rules and it will collaborate closely with the Treasury in evaluating the need for broader legislative reform in respect of the AR regime. Specifically, the Treasury is considering whether to enhance the role and powers of the FCA, for instance by introducing a 'principal permission' gateway, a newly-designed FCA permission that authorised firms would need to acquire before acting as a principal and appointing an AR.

Other proposals involve placing further responsibilities on ARs, including extending the FCA's Senior Managers and Certification Regime to ARs. The Treasury is reluctant, however, to impose excessive regulatory burdens on ARs, as this would tend to further align the regulation of ARs with that of authorised firms and reduce the benefits of operating as an AR in term of cost and time efficiencies.

In parallel, the FCA will keep under review other elements of the AR regime it still considers to be potentially problematic, in particular, the regulatory hosting model. The economic relationships between principals and ARs will be subject to further study, especially where these are unbalanced in favour of ARs, which may exercise undue influence over principals.

The FCA is also likely to intensify its supervision of overseas ARs, and to assess whether any restrictions should be introduced on the scope of the activities overseas ARs may carry out. Finally, the FCA has considered whether prudential standards for principals and ARs ought to be enhanced, but there is no indication that changes on this front will be implemented in the near future.

Trainee solicitor **Pietro Piazzi** contributed to this article.