

Alert | Financial Regulatory & Compliance



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Principals in the Spotlight as UK's FCA Consults on Changes to Appointed Representatives Regime

This GT Alert covers the following:

- Proposed FCA reforms to the UK Appointed Representative Regime that seek to address the risk of consumer detriment arising from inadequate oversight of Appointed Representatives by Principals.
- A proposed increase in the regulatory burden on Principals, including in respect of oversight and reporting to the FCA.
- Risks for Appointed Representatives including increased fees and de-risking by Principals.
- Regulatory hosting arrangements under review.

The Appointed Representatives Regime (ARR), a well-known and important feature of the UK regulatory landscape, enables certain businesses – Appointed Representatives (ARs) – to conduct regulated activities without having to be authorised by the Financial Conduct Authority (the FCA). For all ARs, a fully authorised firm (a Principal) holds the relevant regulatory permissions and is responsible for the conduct of the AR acting under those permissions. The FCA is concerned that Principals and ARs are the source of a disproportionate level of consumer harm due in large part to substandard oversight by Principals. The FCA is therefore now proposing significant new rules and guidance that seek in the main to increase the regulatory burden on Principals to oversee ARs and to provide information to the FCA. According to the FCA, there are currently around 40,000 ARs with 3,600 Principals. This consultation is therefore of wide significance.

Background to the Consultation

Whilst proper functioning of the ARR depends on the quality and level of effective oversight by Principals, in general the ARR operates well and plays an important role in lowering the cost and resource barriers to entry into the UK regulated sector.

However, the FCA is concerned that ARs account for a disproportionate amount of consumer harm. For example, a high proportion (61% in the period 2018 to 2019) of Financial Services Compensation Scheme (FSCS) pay-outs relate to ARs or Principals. Principals also receive significantly more complaints per £1m of revenue than non-Principals. The FCA attributes these trends in large part to inadequate supervision by Principals. Therefore, many of the proposed changes (summarised below) seek to impose a greater regulatory burden on Principals and require them to provide more information to consumers and the FCA so that Principals can be more effectively held to account.

Summary of the Changes Under Consultation

The proposed changes of greatest significance are summarised below. We then provide some general comments about how these proposed reforms may impact Principals and ARs:

1. *More information about ARs to be provided to the FCA.*

At present the information available to the FCA and the public regarding ARs, via the Financial Services Register (the public database of all UK regulated firms and individuals), is limited, making it harder to determine whether an AR is acting within or outside those activities that the Principal has accepted responsibility for and has permissions for. Therefore, the FCA proposes to require Principals to provide additional information about its ARs and their businesses including: why the Principal proposes to appoint an AR, the AR's revenue, whether it will deal with retail clients, the number of complaints that relate to it (rather than the Principal) and what its regulated and non-regulated activities entail. This will give the FCA a meaningful snapshot of the AR as a business and (as important) as a source of potential risk. This will apply to existing and new ARs, and significant changes will have to be reported.

In addition, to provide consumers and interested third parties with an understanding of what the AR is permitted to do, the FCA proposes that the Register include details of the regulated activities the AR performs.

2. *Increasing the responsibilities of Principals for oversight of ARs*

Some of the proposed changes clarify and enforce existing rules and guidance. But there are also significant new expectations and rules that may (if adopted) significantly change the landscape of the ARR. For ease of reference we have categorised the proposals as relating to oversight, risk and annual review and self-assessment.

Oversight

New guidance is proposed as to the “*reasonable steps*” that Principals should already be taking to ensure that ARs act within the scope of their permissions. There is also proposed new guidance on the level of monitoring and oversight that the Principal must be content that it has before it starts or continues with an AR, including guidance as to when to review arrangements in light of the growth of an AR's business. The FCA says it has seen many cases of Principals being unable to cope with significant growth of an AR. Indeed, a new rule is proposed requiring a term in the contractual arrangements between the Principal

and the AR that will allow the Principal to terminate arrangements when it feels it can no longer adequately oversee the AR's business.

Guidance is also proposed clarifying that Principals should oversee financial services staff at ARs to a comparative level as if they were directly employed by the Principal. This should be achieved through, for example, the collection and scrutiny of management information, the review of the AR's business activities such as call scripts, regular engagement with ARs through meetings and calls and a clear articulation of what issues/concerns need to be escalated to the Principal and when.

Risk

The FCA proposes that Principals be required to assess whether its ARs generate a risk of undue customer harm, including to potentially vulnerable individuals. If so, Principals will be expected to act, for example, by strengthening controls or even ending the relationship, before such risks crystallise. This aligns with the FCA's work on the new Consumer Duty and around the protection of vulnerable retail customers.

Under existing rules in certain extreme circumstances (e.g., where an AR is no longer suitable by dint of its ownership) a Principal must take immediate steps to terminate an AR relationship or to remediate it. However, the FCA recognises that "*most issues should be fixable.*" It therefore proposes some guidance as to when termination may be the appropriate step, to ensure that Principals do not terminate relationships prematurely and that issues are remediated where possible. An example of this proposed guidance is where the AR is found to be acting beyond the scope of its appointment.

Annual Reviews and Self-Assessment by the Principal

The FCA proposes to require Principals to conduct an annual review of certain aspects of an AR's business and the ability of the Principal to oversee it. The proposal is that Principals will also be required to conduct an annual review of the senior management of the AR to make sure that they are "*fit and proper.*" ARs are not subject to the Senior Management and Certification Regime (SMCR), and at present this creates an anomaly in terms of the level of scrutiny applied to the initial and ongoing fitness and propriety of ARs. This change will in part address this anomaly but may be burdensome on Principals if done properly, as ongoing competence can be difficult to assess by a person outside the business. The FCA propose that more frequent reviews may be required depending on the Principal's assessment of the risks posed by the AR.

The FCA also proposes that in respect of each AR, the management body of the Principal must approve a self-assessment document that sets out various key indicators such as: the ways in which effective oversight is being achieved, the level of risk of harm that the AR poses and how the Principal is satisfied that the management of the AR are fit and proper. Whilst the FCA does not propose that this is filed, it is to be made available on request, and the FCA hopes that the compilation process will be a useful exercise for Principals.

1. Introducer Appointed Representatives

Some of these proposed changes will not apply to Introducer Appointed Representatives (IARs). IARs are only allowed to undertake limited activities: making introductions and distributing financial promotions. The FCA recognises that it would be disproportionate for all aspects of its proposals to apply to these arrangements. For example, the information that a Principal must provide about its AR and the reasons for its appointment is more limited.

Other Areas for Potential Policy Change

The FCA has also set out areas for potential future policy change. This includes the potential for regulation or even prohibition of regulatory hosting (arrangements where the Principal does not operate in the same market as its AR, or indeed in any financial services markets). The FCA recognises that hosting arrangements can have real benefits, including where they act as regulatory incubators for new entrants into the regulated sector. However, the FCA is concerned that such arrangements are disproportionately the source of complaints and the subject of FCA Supervision. It attributes this in part to an oversight approach that is too light touch given the stage and disparate nature of the AR businesses being supervised. The FCA is also concerned by a trend of secondees from ARs to Principals (regulatory hosts in particular) conducting investment management business or acting as AIFMs under the Principal's permissions. The FCA is seeking to open a dialogue as to how best to regulate in this area. Come what may, the FCA is concerned by these practices and may feel compelled to take action.

Comments and Implications

These proposed reforms are aimed at Principals. However, ARs should also take note. Not only will the level of scrutiny on their businesses increase but (if these proposals are adopted) there is a real possibility of Principals seeking to de-risk their books and terminating certain ARs, or at the very least increasing the fees that they pay. For Principals, the regulatory burden (and therefore the overhead cost) of complying with these reforms will be considerable. Principals come in all shapes and sizes, and there is not necessarily a correlation between size and quality. Nonetheless it is the smaller organisations that may struggle to comply with this increased regulatory burden. ARs and Principals can participate in the consultation, which closes on 3 March 2022.

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