

20 May 2019

Dear CEO

FCA expectations of principal firms in the investment management sector

We have published today on our website the detailed findings of our [multi-firm review](#) into the supervision by principal firms of their appointed representatives (ARs) in the investment management sector (covering firms engaged in the promotion and management of alternative investment funds, asset management, wealth management, contracts for difference providers, fund advisory and arranging activities).

This sets out our findings and the actions we expect principal firms to take to ensure that they meet their responsibilities under [our rules](#) as principals for their ARs.

Our previous [review](#) in the general insurance sector identified significant shortcomings in the control and oversight of ARs by their principal firms. More recent supervisory work within the investment management sector identified similar concerns, prompting us to carry out this [multi-firm review](#).

Our review identified significant shortcomings in relation to principal firms' understanding of their responsibilities for, and the level of control and oversight of, ARs. Many principals did not identify conflicts of interest inherent in this business model or make attempts to manage them. This risks harm to consumers and to the market arising from the activities of ARs operating in this sector.

Findings

Our review found that most principal firms within our review had weak or under-developed [governance arrangements](#) in place, including a lack of effective risk frameworks, internal controls and sufficient resources. As a result:

- Many principals had not taken reasonable steps to assess their ability to oversee their ARs effectively when considering their appointment. So, some ARs were conducting activities outside their principal's core areas of expertise. Some principals were overseeing a wide variety of business models operated by their ARs without putting in

place [sufficient resources](#) to do so, including enough appropriately skilled and experienced people.

- Most principals had not put in place appropriate control frameworks to monitor their ARs' activities on an ongoing basis to ensure they were complying with relevant regulatory requirements and the principals' own policies and procedures.
- Deficient risk frameworks meant that monitoring was not bespoke to the AR's business model. Many principals were not taking active steps to monitor ARs' activities and were reliant on receipt of high-level attestations from the AR. At one principal, a number of ARs were acting outside the scope of their principal's permission, in breach of the [general prohibition](#).
- We have seen rapid growth in numbers of ARs registered by some principals without the associated enhancements to governance and risk frameworks to align with that growth.
- As principals are responsible for their ARs (including any liabilities that arise) they should be assessing risks to their firms arising from their ARs' activities and considering what financial resources are appropriate to meet their obligations. However, most principals were not assessing the risks to their firms arising from their ARs' activities. Where we reviewed firms' assessments of the adequacy of their financial resources (where required under the prudential regime), more than 90% were not fit for purpose. Furthermore, these principals were not adequately assessing their risks across all risk types, including liquidity risk and an assessment of their compliance with the overall liquidity adequacy rule (see BIPRU 12.2.1R). Consequently, these principals may not be holding adequate financial resources for both liquidity and capital (see our rules in [COND 2.4](#)).
- There are inherent conflicts of interest in this model which must be managed (see SYSC 10.1). Some principals did not identify or record any conflicts on their conflicts of interest register despite the existence of some obvious conflicts.
- Some principals were not following our [requirements](#) to include their ARs' revenues when submitting fee tariff data from which we calculate their annual FCA regulatory fees. This meant that they paid lower fees than they should have, with the balance covered by other fee payers.

Responsibility of a firm for its ARs

Our Handbook sets out the rules and guidance on appointing ARs and the continuing obligations of the principal firm. The main purpose is to place responsibility on the principal firm for seeking to ensure that its ARs are fit and proper to deal with clients in its name, and to ensure that clients dealing with its ARs have the same level of protection as if they had dealt with the principal firm itself (see [SUP 12.1.3G](#)).

ARs undertake regulated activities under the supervision of an authorised firm which acts as their principal. A principal accepts responsibility for the activities of its ARs. As such, the [underlying legislation](#) makes clear that: 'The principal of an AR is responsible, to the same extent as if the principal had expressly permitted it, for anything done or omitted by the representative in carrying on the business for which the principal has accepted responsibility'.

An act or omission of the AR, in carrying on the business the principal has accepted responsibility for, is treated as an act or omission of the principal itself (see [SUP guidance](#)). Regardless of any supplementary commercial arrangements with the AR, the principal has full

responsibility (including for any liabilities that might arise) for ensuring that the AR complies with our rules: a breach by the AR is a breach by the principal firm. For example, if we find misconduct within an AR, we contact the principal firm during any regulatory intervention.

The principal will also be responsible for resolving any issues and ensuring that any customers who have suffered detriment receive appropriate redress. The principal firm might seek to recover any costs from its AR; this would be a commercial decision in line with its contractual arrangements. But no contractual arrangements can remove the ultimate responsibility of principal firms, or provide certainty that the AR has financial resources to meet the costs incurred.

We expect you to be aware of, and to meet, your obligations when appointing ARs. You are required to comply with the rules set out in the Handbook, particularly Chapter 12 of the Supervision Manual (SUP), Principles for Businesses (PRIN), Senior Management Arrangements, Systems and Controls Sourcebook (SYSC), Threshold Conditions (COND), Conduct of Business Sourcebook (COBS), Fees Manual (FEES) and where relevant, the Client Assets Sourcebook (CASS), Market Conduct Sourcebook (MAR), Investment Funds Sourcebook (FUND) and the Product Intervention and Product Governance Sourcebook (PROD). See our website for [further guidance](#) on our expectations of principal firms and ARs.

Action required

Given our significant concerns, we expect you to share this letter with your Board or equivalent; we may consider these matters in future interactions with your firm.

We expect you to assess how you are meeting our requirements in relation to your ARs, as set out in our Handbook. You should identify and address any shortcomings in your firm's risk-management frameworks, processes and practices in relation to meeting your responsibilities for, and obligations in respect of, your ARs. If, having taken these steps, you cannot demonstrate compliance with our Handbook and that the risks relating to the activities of the ARs for which you are responsible are being adequately managed, you should consider ending your relationships with your ARs.

We will be conducting further work, including undertaking visits to principal firms, and we expect to see that firms have acted on the findings of this letter. We will take appropriate action where we identify that firms have failed to act.

Yours faithfully

Megan Butler

Director

Wholesale Supervision

Investment, Wholesale & Specialists Division