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FCA Criticise the Use of ARs in the Investment Management Sector – Principal Firms Must Review Arrangements Including in Relation to AIFM Hosting

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The Appointed Representative ("AR") status has provided an efficient way for firms to enter the UK financial services market without having to go through the process of obtaining full authorisation from the FCA.

To recap, AR status is an exemption from licensing requirements under the Financial Services and Markets Act 2000 ("FSMA"). ARs are formally exempt persons. An AR will enter into an agreement with a regulated firm (the "Principal"), which will take responsibility for the AR's activities. An AR can only act within the scope of the Principal's regulatory permissions. Moreover, ARs are not permitted to perform the full range of regulated financial services activities. Most significantly, they are not able to carry on investment management activities. However, they are able to provide investment advice under the Principal's responsibility. More detailed regulatory rules are contained in Chapter 12 of the FCA's Supervision Manual.

The FCA's Concerns

The FCA has been concerned that regulated firms who act as Principal for ARs have not been taking their responsibilities sufficiently seriously. The FCA has previously looked at the use of ARs in the general insurance sector (the results of the Thematic Review being published in TR16/6) and also issued an alert to Principal firms in 2017. The FCA has now turnedits attention to the use of ARs in the investment management sector. This is in the context of a significant growth in the use of the AR mechanism. The FCA report that there are over 1,000 ARs in the investment management sector and that there has been a growth in principals describing themselves as "regulatory host firms".

The results of the FCA's review into the use of ARs in this sector are not positive. As a consequence of this, firms who are presently ARs are likely to see a more intrusive approach from their Principal firms and the costs of maintaining AR status are very likely to increase as the costs (in terms of resources and capital) are likely to rise for Principal firms. It may also mean that Principals will seek to curtail the scope of certain of the activities that ARs presently engage in, particularly in the context of portfolio management activities.

The FCA has published a review of its findings (FCA AR Review) and a Dear CEO Letter on this topic dated 20 March 2019.

Overview of FCA Findings

The FCA's review identified significant shortcomings in Principal firms' understanding of their regulatory responsibilities for ARs.

The FCA found that most Principal firms had weak or under-developed governance arrangements in place including a lack of or deficiencies in:

- Effective risk frameworks;
- Internal controls; and
- Resources.

The FCA's feedback was broken down into five blocks, which we consider below.

AR On-Boarding Process

The FCA identified various deficiencies in the AR on-boarding process. The FCA's expectation is that Principals will carry out due diligence on ARs to understand the AR's business and how this will be supervised by the Principal in the context of the AR relationship.

The FCA found that Principals failed to assess their ability to oversee ARs effectively. Principals need to understand the ARs business model and ensure that this is within the scope of their firm's expertise. The FCA also noted that product governance processes must be extended to include activities carried on by ARs. The FCA found that at most Principals, product governance arrangements were not in place and that Principals were not able to demonstrate that the products offered by ARs had been designed in the best interests of consumers. This may be less of a concern where the AR is only dealing with Professional, and not Retail clients.

Firms should:

- Review due diligence process when ARs are being taken on.
- Review AR contracts/agreements. These should not be standard or generic for all ARs but based on the ARs business model.
- Extend product governance requirements to ARs.

Ongoing Monitoring of ARs

Most Principals had not put in place appropriate controls to monitor the activities of their ARs. Moreover, where monitoring was carried out, it was not bespoke to the model of the AR. Many Principals were not taking adequate steps to ensure that their ARs were complying with relevant regulatory requirements. The FCA found little evidence of file reviews, testing, or challenge being undertaken.

The FCA's work also focused on conflicts of interest issues. The FCA state that there are inherent conflicts of interest in the Principal—AR model that must be managed.

Firms should:

- Ensure appropriate controls are in place to monitor the activities of the AR.
- Monitoring needs to be bespoke to the business model of the AR.

- Monitoring should involve client file reviews, testing or challenge and review of suitability or appropriateness tests.
- Consider the approach to conflicts identification and management.
- Establish processes for the review of ARs websites and financial promotions.

Capital and Liquidity Assessment

As Principals are responsible for their ARs (including liabilities that arise) they should be assessing risk 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 the activities of their ARs.

Firms should:

- Ensure appropriate Senior Management review of financial and other resources requirements required to support activities relating to ARs.
- Senior Management should consider risks arising from their role as Principal firms and appropriate steps to mitigate such risks.
- Consider implications for capital requirements including, for example, additional costs in the context of calculating fixed overheads requirements.
- Consider the impact of AR income on fee tariff data.

Alternative Investment Funds and Host AIFM Models

The FCA commented that recent years have seen an expansion in the Host AIFM model. The FCA state that they have significant concerns with the hosting model and will continue to monitor it. Very broadly, the host structure allows an unregulated firm to set up an Alternative Investment Fund ("**AIF**") using the Principal's permissions.

Under this the Principal firm is appointed as the Alternative Investment Fund Manager ("AIFM") of an AIF. The AR is then appointed as an advisor to the Principal Firm/AIFM. Although the AIFMD permits delegation of portfolio management activities, clearly, no formal delegation can take place where the delegee does not hold any regulatory permissions (AIFMD requires that delegation can only take place to a firm that has MiFID permissions to carry on portfolio management activities). Under the Host AIFM model individuals from the AR may be seconded to the Principal and can carry on portfolio management in this capacity (and be approved to perform the CF30 controlled function for the Principal Firm).

This sort of model can be criticised as an arbitrage of the rules relating to ARs. As already noted, the AR regime does not permit ARs to carry on portfolio management activities, though they can provide investment advice. Seconding a member of staff to the Principal to manage a portfolio blurs the lines between the activities that are being carried on by the Principal and those that are being carried on by the AR. The FCA noted that there are inherent conflicts in a model where employees of the AR are appointed as employees of the AIFM.

Firms should:

- Ensure that you have processes to identify and manage conflicts of interest.

- Principals must establish appropriate control and risk management frameworks, including experienced people, to oversee the AIFs and the activities of the seconded portfolio managers.
- Ensure that market abuse policies and surveillance are extended to the AR's activities.
- Ensure that notification and reporting obligations relating to AIFs (where the Principal is the AIFM) are in compliance.

Foreign Owned ARs and Contracts For Difference Providers

The FCA identified concerns about the risk of consumer harm presented by this misuse of registration of ARs and risks to confidence in the U.K. regulatory system in the CFD sector. In particular, they are concerned that Principals in the contracts for difference sector do not have sufficient systems and controls in place to monitor their ARs.

The FCA expects all Principal Firms to review and act on these matters. The FCA's Dear CEO Letter states that firms who act as Principal must assess how they are meeting their obligations.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

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