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Spotlight on Foreign Firms—UK FCA Sets Out High Regulatory Expectations

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With the end of the Brexit transitional period fast approaching, the Financial Conduct Authority (the "FCA") has set out its high expectations of international firms that operate in the U.K. in its *CP20/20, Our Approach to International Firms,* published on 23 September 2020.

The Consultation Paper is highly relevant for:

- European financial institutions who will become fully authorised and supervised in the U.K. following Brexit; and
- Other international firms who will need to comply with FCA requirements with regard to their resourcing, governance arrangements, relationship with Head Office and responsibility for regulated activity liabilities.

Unusually for a consultation paper ("CP"), the FCA is not proposing to change any of its rules through the CP. Rather, the FCA sets out its expectations for "international firms" operating in the U.K. The CP describes how the FCA will assess these firms against minimum standards and its general expectations for these firms. The CP also explains the circumstances where these international firms could present higher risks of harm and how those risks can be mitigated.

I. Whom does the CP apply to?

What is an international firm?

The CP applies to firms operating in the U.K. whose home jurisdiction is a state of the European Economic Area ("EEA") (e.g., Germany) or a non-EEA State (for example, the U.S.). Much of the focus of the CP is on international firms operating from a U.K. branch. However, the FCA states that the CP might also be relevant for U.K. subsidiaries with overseas parents.

The CP appears to us to be highly relevant to all U.K. authorised firms, whether established in the U.K. as a branch or subsidiary, which are part of a group based outside the U.K. The CP closely examines the relationship between the U.K. business and head office or other non-U.K. operations. U.K. authorised entities will typically be reliant on group entities for the provision of financial resources, intra-group outsourcing and management.

Brexit and EEA Firms

The CP is relevant to EEA firms who will have to obtain full U.K. authorisation following the end of the current Brexit transitional period. This includes firms who will operate (at least initially) without a full U.K. authorisation under the Temporary Permissions Regime. European firms who have operated in the U.K. under passporting rights have not been required to comply with the full range

of FCA and PRA rules. The allocation of responsibility between Home and Host States under the Single Market Directives (e.g., MiFID II) has meant that EEA firms have been able to comply with the rules of their Home State for many important regulatory and supervisory matters. This is set to change with the FCA and PRA assuming greater supervisory responsibility for EEA firms.

Branch versus subsidiary

The CP notes that international firms can choose to operate in the U.K. either as a branch of the non-U.K. firm or as a local U.K. subsidiary. In both cases, where authorisation is sought, the authorisation will cover the whole entity. In the case of a branch, the Head Office located outside the U.K. will also be an "authorised person" and subject to the jurisdiction of the FCA.

There are some advantages to operating as a branch. For example, in the case of a branch, regulatory capital might be assessed on a legal entity basis, meaning that it will not be necessary to capitalise a separate U.K. subsidiary (or have allocated capital). However, a branch can be more difficult for U.K. regulators to supervise and take action over, given that the same legal entity will be subject to foreign law and supervision by a foreign regulator.

The FCA expresses a clear preference for firms to be established in the U.K. as local subsidiaries. They emphasise the additional risks that arise from firms being established in the U.K. as branches and the need for relevant risk mitigants. The FCA states: "*However, we believe that, without appropriate mitigation, certain potential harms could be more likely to occur where the regulated activities are undertaken by international firms from branches rather than through U.K.-incorporated subsidiaries*".

II. What are the requirements for authorised firms?

Nature of a firm's operations

All authorised firms must be capable of being effectively supervised, taking into account the complexity of the firm's regulated activities, products and how the business is organised.

The issue of local substance is an important consideration when establishing a U.K. firm. Firms must be able to demonstrate that mind and management are located in the U.K., and that key functions are based there as well. If the firm's centre of gravity is located outside the U.K., the firm might struggle to show that it is being run independently with a view to compliance with U.K. requirements. Of course, the FCA accepts that an overseas parent or head office will have a close economic interest in the U.K. operations. However, those operations must be run from the U.K. and prioritise compliance with U.K. regulatory requirements. This can set up a position of conflict, which the FCA recognises, where the economic interests of a parent might jeopardise the ability of the U.K.-authorised firm to comply with its U.K. obligations. This could, for example, be in respect of ensuring that the U.K. firm is properly resourced or in ensuring that the U.K. firm is sufficiently funded to meet remediation or Financial Ombudsman liabilities.

The FCA states that it requires assurance that personnel (including management and decision-making structures) and systems and controls (taking into account any offshore or outsourcing dependencies) are adequate for the firm's U.K. activities to be effectively supervised.

They will also assess whether the U.K. operations are appropriately resourced financially by the firm as a whole, to avoid the risk that the firm cannot meet any legal and regulatory obligations arising from the operations of the branch.

The degree of cooperation between the FCA and the Home State supervisor is important to ensure that there is a proper flow of information.

Personnel and decision-making

Personnel and decision-making processes are important in the context of the resources and suitability of the firm. Key issues identified by the FCA are:

- Application of the Senior Managers and Certification Regime ("SMCR"). The SMCR has applied only to a limited extent to passporting EEA Firms. Such firms will need to consider the impact of Brexit on internal governance arrangements and individual accountability.
- Senior managers who are directly involved in managing the firm's U.K. activities need to spend an adequate and proportionate amount of their time in the U.K.
- Individuals outside the U.K. whose involvement in U.K. operations is confined to purely strategic matters can be located outside the U.K.
- Individuals responsible for the day-to-day management of the U.K. branch will need to have sufficiently independent decision-making powers and to exercise independent challenge over strategic decisions that affect the wider firm.

Systems and controls

Firms authorised in the U.K. must have appropriate non-financial resources including systems, controls and human resources.

As already noted, international groups will tend to use centralised services and intra-group outsourcing. Important points in this respect are that:

- Outsourcing arrangements should not impair the quality of the firm's governance and internal controls and the FCA's ability to supervise the firm.
- Where an international firm's U.K. operations are dependent on services provided from other locations of the firm, the FCA will consider whether these arrangements impair the FCA's ability to supervise the firm effectively.

In practice, the FCA is well used to firms relying on outsourcing so that the concerns raised by the FCA mean ensuring that these arrangements are appropriately structured, documented and supervised.

Home state jurisdiction

The FCA will supervise the entire legal entity that it authorises and grants permission to operate in the U.K. to. An FCA authorisation, therefore, applies to the legal entity incorporated outside the U.K., including its U.K. branch and its overseas head office. The FCA says that they must have comfort over the jurisdiction where the firm is incorporated, and how the arrangements in that jurisdiction affect the ability of the firm to meet the relevant minimum standards for authorisation.

III. What are an international firm's risks of harm?

Retail harm

Retail harm is one of the three areas of risk that the FCA focuses on in its CP. The FCA says that their focus is on international firms that conduct regulated activities with retail customers (which may include firms that manufacture products that are ultimately sold to retail customers).

The non-payment of redress applicable under the relevant U.K. rules is the primary concern of the FCA here. A person in the U.K. seeking redress from a branch of an international firm may be more dependent upon the cooperation of the international firm's head office or, in the case of the firm's

insolvency, the position of U.K. consumers under the Home State's insolvency rules. This creates a risk of harm to eligible complainants to whom the Financial Ombudsman has made an award, eligible claimants in the event of the firm's insolvency and consumers who are due redress.

When assessing an international firm, the FCA will pay more attention to the risk of the following factors occurring and what assurances can be provided by the firm to mitigate them, including:

- poor quality of governance leading to inappropriate sales practices;
- inadequate disclosure of product information;
- inadequate management of conflicts of interest between how firms generate revenue and consumer needs
- flaws in the design and implementation of systems and controls;
- failure to hold adequate professional indemnity insurance and capital to meet liabilities;
- inadequate arrangements to maintain technology resilience and cyber security; and
- failure to establish adequate controls to prevent financial crime such as scams.

To mitigate the risk of retail harm, an international firm should consider the relationship between its U.K. Branch and Head Office. A firm should, for example, ensure that the U.K. branch has its own management or significant independent oversight as part of its governance structure. Other mitigants to lower the risk of retail harm may include ensuring the products and services that are developed by other overseas branches are suitable for the U.K. market, and the firm's people exercising control functions have adequate U.K. regulatory or legal experience and knowledge of the U.K. market.

Client asset harm

The FCA's focus here is on international firms that safeguard custody assets or receive or hold client money; in particular, client assets subject to the client assets sourcebook ("CASS"). Under MiFID II, client money and assets are treated as prudential matters, which are the responsibility of the firm's Home State regulator. The end of the transitional period will mean that European firms will need to comply with CASS and be supervised for compliance by the FCA.

The FCA state in the CP that if an international firm safeguards client assets from a U.K. branch, it will generally be required to comply with U.K. rules on the protection of client assets while the firm is a going concern. There could be a mismatch between these U.K. protections and the Home State laws and could negatively impact the protection for the client, as rules might only be partially applied, or might be applied only if certain conditions are met. This is particularly applicable with insolvency regimes, which can vary considerably across jurisdictions, as there is little harmonisation of insolvency law at international level. The recognition of trusts and the segregation of money and assets from the firm's own assets varies tremendously across jurisdictions.

When assessing whether these harms can arise in particular situations, questions the FCA may consider include:

- Recognition of property rights: Will U.K. clients' rights to their assets be recognised under the home state insolvency regime? Will the segregation of client assets from the firm's general estate at the point of insolvency be respected?

- Client interaction with home state insolvency: Will U.K. clients be treated in a way commensurate to U.K. expectations when exercising a claim to their client assets?
- Effectiveness of home state insolvency process: Will client assets that were safeguarded from the U.K. branch be distributed in a timely fashion? What influence, if any, will the FCA or other U.K. authorities have over the protection of clients of the U.K. branch?

International firms can reduce the risk of client asset harm by, where necessary, providing the FCA with information about their clients and how their assets would be treated if the firm enters into insolvency proceedings. A firm must consider this risk of harm and be capable of explaining mitigations put in place to account for such a risk. If the FCA has strong concerns, one possible option an international firm could consider is to structure its arrangements so that client assets are not safeguarded from its U.K. branch, to the extent that doing so would better protect custody assets. Alternatively, establishing a U.K.-incorporated subsidiary is another possible option for the international firm to consider, which could ensure that there is consistency in the treatment of client assets in the U.K. between the safeguarding regime that applies during the life of the firm and the law that would apply in an insolvency.

Wholesale harm

The FCA's focus here is on the potential risk of harm to U.K. financial markets and the U.K. economy that could be caused by an international firm operating in U.K. markets. The FCA acknowledges that it may be difficult to effectively identify shocks or prevent risky behaviours that originate from an international firm's overseas office, which could cause significant negative impact in U.K. markets. This may particularly be the case if the firm's U.K. branch is highly interconnected with or reliant on its overseas offices, and if supervisory cooperation in oversight and information sharing is insufficient.

Common underlying factors that the FCA believes can increase a firm's ability to impact U.K. markets, and, thus, its potential to cause harm in them, include:

- a lack of substitutability of the products and services that the firm offers in the U.K. market(s) where it operates;
- the firm occupying an important position in the U.K. market, for example where it has significant market share in a niche market or otherwise has significant influence; and
- the firm being interconnected to other firms in the industry, resulting in spreading and amplifying risks in the system, rather than reducing or absorbing them.

The level of supervisory cooperation, the prudential regime the firm is subject to, and the credibility and quality of its wind-down planning are all factors, which will affect this level of risk.

IV. Limitations and requirements

International firms should be encouraged to mitigate the above risks as much as possible, as the FCA may impose limitations or requirements on a firm's permission if it is not satisfied such risks are sufficiently accounted for on an ongoing basis. A limitation could be placed on a firm's permission to restrict its activities to reduce the potential for harm. For example, the FCA might limit the number or category of customers a firm can deal with, or the number of specified investments that a firm can deal in. Alternatively, a requirement might be placed on a firm to require it to take or refrain from taking certain action. Additionally, a firm may be required to not to take on new business, or not to trade in certain specified investments.

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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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