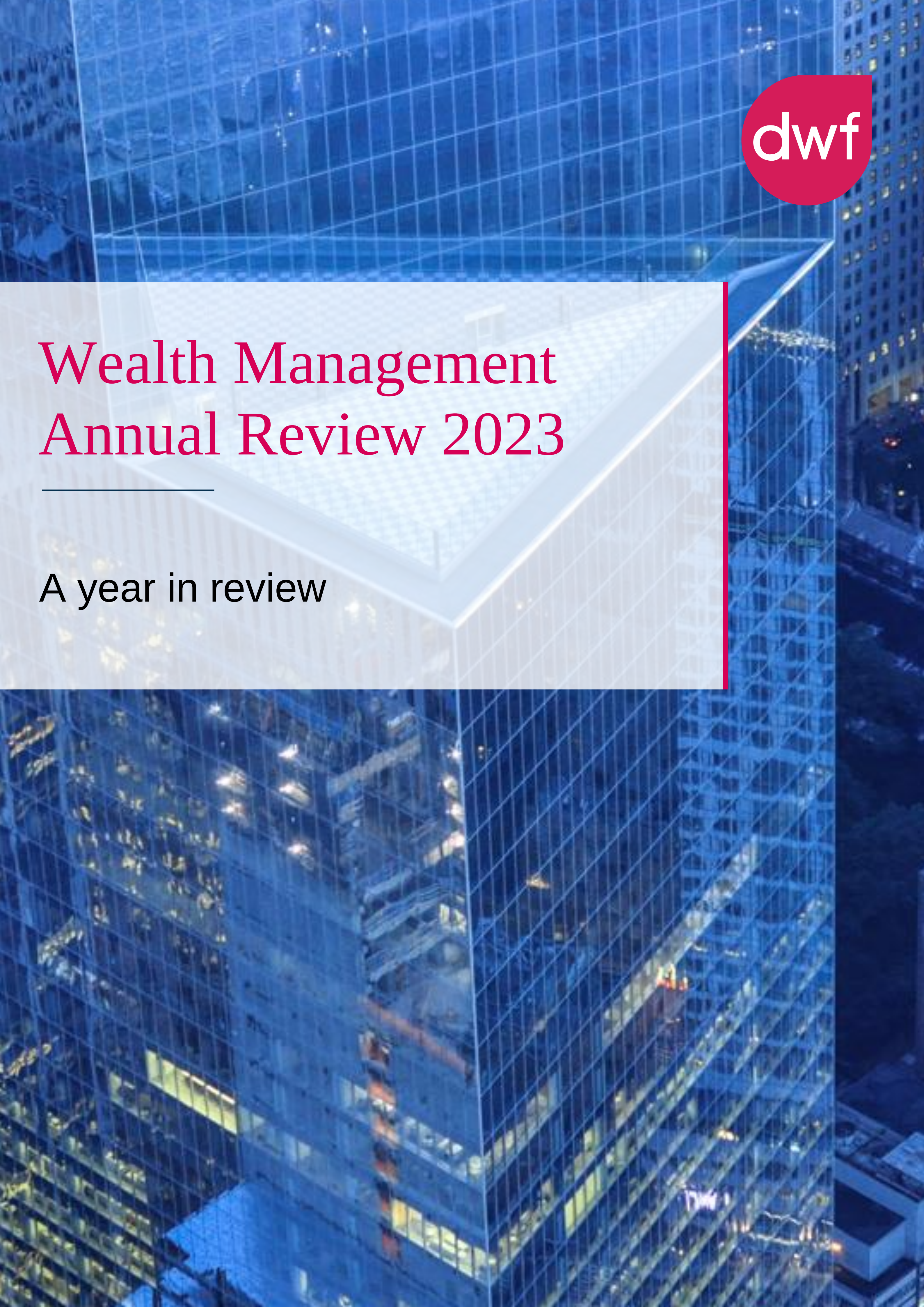
Wealth Management Annual Review 2023

A year in review



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Editors' Note

Happy New Year. We hope the start of 2024 has been calmer than the end of 2023 - unless you're responding to the FCA's Dear CEO letter on retention of client interest! With every New Year comes our Wealth Management Annual Review, so welcome to our review of 2023 – our fourth such report.

The year was a game of two halves, with regulatory initiatives continuing at pace. The first half was dominated by the lead up to the Consumer Duty. The second half involved a deluge of pre-Christmas crackers, gifted to the industry by an ever more interventionist and politicised regulator.

In this report we cover the main issues and areas of regulation that we have found to have affected firms and their senior managers, creating varying levels of challenge, and all proving that the industry is not going to stand still. Although the Consumer Duty has been and will continue as the driving force, we also consider regulatory due diligence as part of M&A activity which is likely to heat back up in 2024. We have articles on progress with the Financial Promotions rules and the implementation of the IFPR – and a note on the capital deduction for redress consultation (or 'polluter pays' rules). FinCrime specialists have highlighted key Financial Crime issues for wealth managers and provided a Sanctions update. We cover the further changes to the AR regime which remains a regulatory priority. Our new Sustainability consultants write about the 'Integrity Gap' and other ESG considerations. We have a Pensions lawyer's perspective on the hot topics in the personal pensions and SIPP market. We finish with commentary on the Advice Guidance Boundary Review and the increasing burden on Platforms, and the FCA's recent troubles delivering Enforcement outcomes in the higher Courts.

We are delighted that our team of specialist wealth management lawyers and consultants is now strengthened by the arrival of our 'ESG and Sustainable Business Consultancy' team, led by Tracey Groves. Liz Ramsaran has joined our Pensions team with expertise in personal pensions, helping with one of the market's highest profile SIPP operator failures. We also feature Lucy Tolond, who specialises in Financial Risks and PI for investment firms.

Our in-person Wealth Management Forum roundtables continued during 2023 for senior legal, risk and compliance people from the larger firms. If you or anyone in your team would like to be added to our wealth management distribution list to receive information about our latest events and articles, please do contact us.

We hope you will enjoy the fourth edition of our WMAR, under a new editorial team, with Sarah giving Aaron a year off. Please do contact any of us if you have any questions or want to discuss how these or other regulatory issues affect your firm or you personally.

With best wishes for 2024

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Consumer Duty – welcome to the future

This past year saw the implementation of the Consumer Duty, which signified a paradigm shift in the FCA's expectations of firms. The FCA is 'talking a big game' on its intention to use the Duty to be assertive, which has been borne out in practice already, and expects the Duty to be a top priority, with firms embedding the interests of customers into the culture and purpose of their business.

In November, the FCA issued a Dear CEO letter[1] to wealth managers and stockbrokers (the WM&S Letter), reminding them that they should already have implemented the Duty in full by making "meaningful changes". The FCA stated:

> "The level of assets under management, combined with the seriousness of these key harms, make this one of the higher risk sectors of financial service firms in our jurisdiction".

The sector should prepare itself for significant regulator engagement and, if it remains dissatisfied, more regulatory action. At the FCA's December 2023 webinar, the panellists stated they believe that consumer investment firms still have a "long way to go."

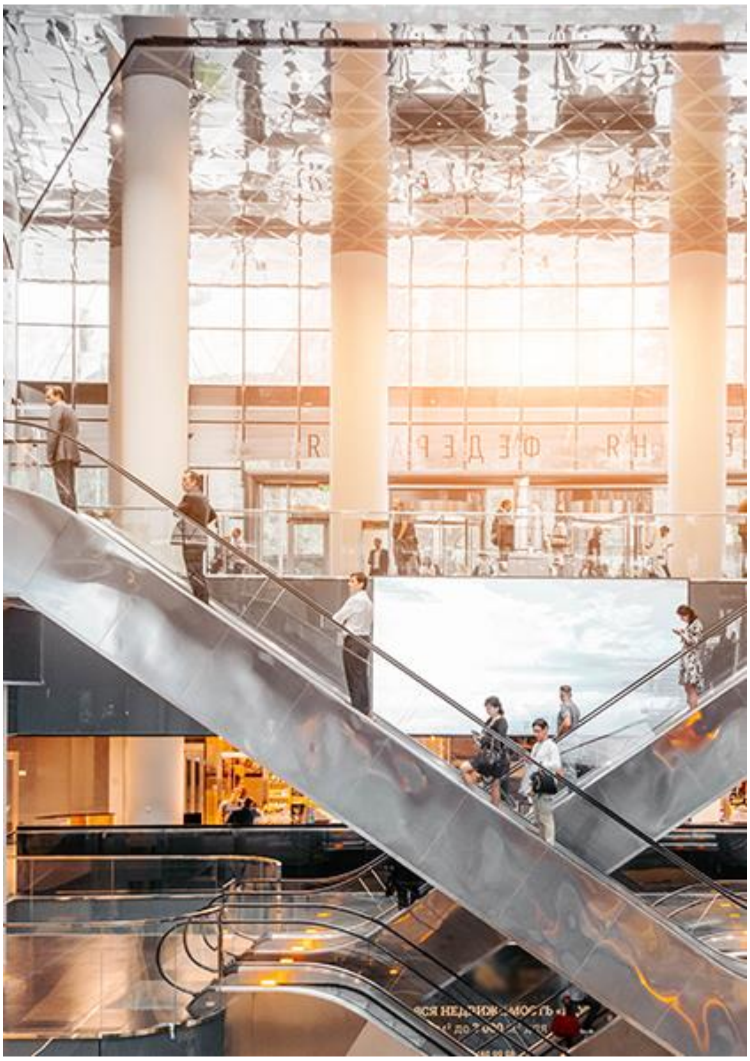
With this in mind, we have identified a number of key areas to consider and which should still be on the to-do list in the wealth management space for the coming 12 months.

Framework, implementation and data

Firms should continue to challenge their framework and the evidence they rely on. The recent multi-firm review (in banking) highlighted that it was good practice for firms to have developed frameworks with clear expectations. Is it clear from the firm's documentation what a good outcome is for the firm's client? If not, how can this be communicated to employees and how can it be monitored?

Following on from this, how has the firm ensured relevant teams understand the expectations of them? One such way is the creation of user guides. This will also help to demonstrate to a third party, whether an auditor or regulator, how the firm is embedding the Duty in practice.

Data is ever-important in any business and this holds true for firms seeking to comply with the Duty. Firms that rely on a range of data points, rather than a single source of insight, are better able to consider different types of customers and outcomes for customers in different scenarios. This will make the frameworks put in place by firms more robust. Additionally, those firms are far more able to monitor and identify issues as they arise.



[1] Dear CEO letter: FCA expectations for wealth management & stockbroking firms

Pricing (or should we say value?)

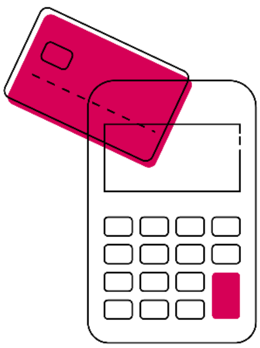
Pricing / value is clearly top of the FCA's agenda. Clients should receive fair value from the products and services they purchase. This means that the price a customer pays for a product or service must be reasonable compared to the overall benefits. This is a nebulous concept, which makes the fair value assessment (FVA) difficult.

Based on the FCA's commentary to date, firms need to be able to answer coherently, with evidence, why their total fee is acceptable whilst identifying and addressing any specific concerns raised by the regulator or which arise from their business model. The WM&S Letter identified three such specific areas of focus:

- Firms charging for services which are not delivered (such as ongoing advice);
- Overtrading on portfolios to generate high transaction fees; and
- Providing a product or service that does not align with the needs of consumers (such as an expensive discretionary offering for a low-risk consumer).

These are not new concerns and the FCA has been trying to crack down on them for a while. However, the FCA appears to be emboldened by the Duty to press this home. It is far easier for the FCA to pick apart an FVA than it was to prove that a firm was not acting in its clients' best interests. We expect the FCA to look at the totality of the firm's fees as well as individual components when assessing fair value. Even if the fees are deemed generally reasonable, if the firm cannot justify an element of its charging, this will still be considered non-compliant. We have also seen the FOS question the value of DFM services in some circumstances, which is seemingly in line with the FCA's concern.

There is also a significant focus on the retention of interest, which we discuss below. We also note that the requirement for distributors to consider the whole cost of the distribution chain is starting to create pressure up and down the chain. It is noticeable that there are a number of questions in the latest FCA survey sent to wealth management firms that go to these points. We expect some firms to have additional questions posed – or worse.



The FVA

The FVA is not straightforward. It is important that firms define and measure fair value. In the WM&S Letter and another more recent Dear CEO letter addressed to investment platforms and SIPP operators (the Interest Letter), the FCA identified concerns about:

- Failing to identify all revenue streams paid by a consumer in the "value chain"; and
- 'Double dipping'.

Whilst this related more specifically to the retention of interest on client money, it is easy to identify a number of other examples of multiple charges in investment services. For example, a vertically integrated firm could (in theory) charge an advice fee, platform fee, DFM fee and a fund fee (in addition to retaining interest on clients' money). Most firms are conscious of this and take an holistic approach but firms need to be alert to this.

We have also seen firms, at times, failing to a) recognise and/or b) justify using the same operational cost to the business for multiple income sources, i.e., taking the retention of interest as an example, retaining interest and charging a platform/custody fee that also takes the cash into account. Some firms may, in part, use the operational costs to justify this approach without recognising that it's the same cost being used to justify two different charges.

Firms need to identify what data they have or can obtain to allow them to quantify their FVAs. In the investment world, it can be difficult to determine how to quantify the benefit a client receives. One could consider performance but, particularly for passive investment strategies, that is largely reliant upon the market, which a firm cannot control. Perhaps, if you're an active investment manager, you can consider how you have performed compared to the chosen benchmark but what does this mean if you have a poor year? Not everyone can beat the market, so does failing to do so mean one fails the FVA? The short answer is 'no', but it highlights the need to scrutinise the implications of the evidence relied upon.

In a speech in November, the FCA stated that it has already seen firms reviewing their fees with fair value in mind. Anecdotally, we have also heard of firms changing, and often reducing, their fees - while some increase or harmonise theirs - and so it appears the FCA's focus is having an effect. That said, it appears to us that the expectations on firms are increasing year on year so it is difficult to see how, in the long term, it will not lead to increased charges.

Interest

A specific example of the concerns identified by the FCA about fair value is the retention of interest earned on client money. It is one of the FCA's most pressing concerns, especially in the newly higher interest rate environment and amid press attention. We've already seen significant focus on banks and their rate differentials and this has now been turned on investment platforms, SIPP operators and custodians.

The FCA's September platforms portfolio supervision strategy letter (the Platform Letter) listed the payment of interest as one of the two "emerging risks of harm". It stated that:

> "where interest payments are accrued on customers' cash balances held by firms, this should be carefully considered as part of FVA"

The Interest Letter provided context regarding some of the FCA's work and observations:

- A majority of firms sampled retained interest, varying between 10% to 100% with an average of 50%;
- 61% of firms charged a platform fee on the customer cash they hold;
- A high degree of variance in the disclosures made to clients; and
- Only 48% of sampled firms gave examples of actions they had taken in relation to the retention of interest because of Consumer Duty expectations.

The FCA wants investment platforms and SIPP operators to end the practice of 'double dipping'. In the context of the Platform Letter, as a minimum, this is referring to a platform charge (however phrased) taken in respect of the cash balance whilst also retaining some or all of the interest. The FCA also seems surprised that under half of firms gave examples of actions taken in relation to the retention of interest post-implementation of the Duty.

The increased focus on the retention of interest on cash balances makes it clear that firms cannot rely solely on the CASS rules to justify retaining a significant amount of client interest.

Client Communication

Another key area of the FCA's focus is client communication. Aside from the actual pricing charged by firms, the FCA has flagged (a number of times) the need for clients to understand charges; establishing transparency is a key component of providing fair value.

In the Platform Letter, the FCA stated it "will be undertaking proactive work on fair value and transparency in costs and charges, with an immediate focus on retention of accrued interest payments on customers' cash balances". We expect this principle to be applied more widely across the investment sector throughout 2024 and 2025.

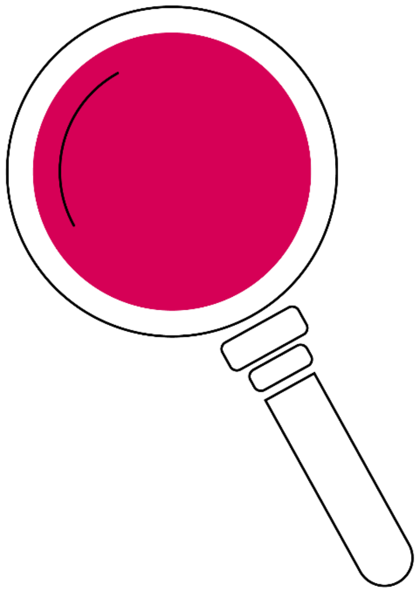
From the various FCA feedback letters we have seen over the past few years relating to client file reviews, a key issue has always been the adequacy of the disclosure within suitability reports. Many advisers' responses to this is that more was inevitably discussed but not fully recorded. All firms should now know that, according to the FOS and the FCA, 'if it's not written down it didn't happen'. It's also fair to say that a client being able to read something in their own time is easier to digest than a conversation.

We expect the FOS to focus further on this as part of its complaint reviews and can foresee CMCs pushing this angle. The FCA will also be keeping a close eye on how investment firms communicate with their clients.

Financial Crime

Whilst there are a host of standalone financial crime considerations outside the context of the Duty, the FCA has highlighted time and again the expectations on firms to prevent customers from being scammed and defrauded. We expect the FCA to use the Duty to pressure firms further to accept liability where clients are scammed. Strong product governance policies and procedures should go some way to address this but may limit investment options. Perhaps that is the intention but then, when you consider the work underway to encourage investment into the private sector (long-term asset funds in pensions, for example), firms will need to consider carefully the commercial viability of advising on, arranging and dealing in certain asset classes.

As a linked point, in our platform article, we explore the apparent extension of SIPP operator non-standard asset liability to platforms.



Now what?

Firms are working through their closed products ahead of the July 2024 Duty deadline. We have not seen much concern expressed by firms in the wealth market and suspect there is a relatively limited number of relevant products compared to other sectors.

Another deadline for firms in July 2024 is the annual assessment report that has to be reviewed and approved by the firm's governing body. The FCA has warned that:

> "this assessment will be part of the evidence we use to assess a firm's ongoing compliance with the Duty."

Whilst this is an internal governance process, firms will want to ensure that the FCA reviewing it 'cold' will be able to see the various critical areas covered comprehensively. This feeds into the message that:

> "The Consumer Duty isn't once and done".

Indeed, the FCA considers that the Duty is still not fully implemented and we understand Skilled Persons' reviews have already been ordered into wealth managers' failures to comply.

We also expect the Duty to require continual change over a period of time. What may be acceptable now may not be in five years' time and firms need to stay alert to what is happening in the market. An obvious but important tip is that firms should not read FCA publications too narrowly. For example, the Interest Letter was aimed at platform providers and SIPP operators but its points would apply to a number of other firms that retain interest. Additionally, the points can be extrapolated – for example, 'double dipping' is not just an interest and cash charge issue.

We have already seen the FCA use the Duty as additional reasoning for using its supervisory powers. We expect this to increase in the short term and become a standalone reason. We expect the FCA will want to lay down markers with Enforcement action in the medium term. More will be known this year, after the FCA carries out its third survey of firms and how they have embedded the new rules (as foreshadowed by the FCA in its November speech).

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Wealth Management M&A DD – regulatory red flags

The wealth management sector continues to see a consistent level of M&A activity – and we expect more this coming year – from big-ticket deals as the market leaders seek to consolidate their position, to smaller, strategic, growth-motivated acquisitions.

The level of activity has kept us busy over the past twelve months and we've worked with a wide variety of clients, including global private equity firms, pan-European insurers and national consolidators and IFA networks to undertake regulatory due diligence on various scales.

What have we looked at?

The regulatory compliance review we undertake is specific to each target's business and regulated activities, but as a minimum the review typically looks at the following areas:

- FCA correspondence history (including any disciplinary action);
- FCA financial returns and compliance with prudential regulation, including group consolidation;
- Internal governance and systems and controls against FCA objectives;
- Suitability as evidenced in client investment and pension transfer files (including conducting file checks);
- Investments sold (standard and non-standard) as part of the above;
- Professional Indemnity Insurance cover (including exclusions);
- Client money and assets (CASS) controls;
- Complaints handling and complaints history;
- IT governance, systems, and controls against financial and cyber crime;
- Senior Managers and Certification Function roles, responsibilities and contracts; and
- Financial Crime risk frameworks.

What do we see?

Historic DB exposure continues to be a concern

With the FCA continuing to take Enforcement action against firms found to have provided poor advice as part of the British Steel Pension Scheme saga, historic pension transfer advice is understandably an ongoing concern. We have seen firms active in the acquisition market wanting to ascertain, very early on in their enquiries, what level of exposure there might be to historic pension transfer advice. Should any such exposure exist, particularly for smaller deals, the potential liability is often calculated as being far higher than the value of the deal. In these cases, we have seen firms opting to evaluate the historic advice before proceeding into the wider due diligence piece such is the importance of understanding the level of exposure. More often than not, the smaller deals involve the purchase of small IFA practices whose principal is looking to retire, leaving behind the "bad book" of business is not an option.

From the buyer's side, the steps to be taken are obvious; from the seller's side however there are steps you can take to help prepare for when the inevitable question is asked:

- Ensure you have documented all of the advice you have given on the transfer of safeguarded benefits;
- Provide a quantum for the buyers that indicates the total value of benefits transferred; and
- Be open and honest in your communications with the buyers – if you've had complaints or regulatory intervention in the past, even if they came to nothing, this should be disclosed as early as possible as finding this out late in the day might be a deal breaker!

Wind down planning…or lack of

No firm wants to consider what might happen in the event that they have to wind down their business and cease trading and this is evident by the lack of wind down planning we see as part of our reviews. The FCA expects this to be in place, but we often hear "there's only three of us".

If between you there are several million pounds worth of assets under advice and several hundred clients that are being serviced, you must have a plan in place to ensure that they do not come to harm as a result of the target firm being wound down. What this means in reality for the buyers depends on the plan going forward. However, it does demonstrate a potential lack of understanding as to how the FCA's rules apply to the target and could also indicate a wider cultural issue within the target. More often than not, it is simply that the target does not consider itself of sufficient size to need to have one in place.

Business Continuity

Similar to wind down planning, business continuity planning is often overlooked in the smaller transactions. Again, this is often down to the size of the target firm but we also see issues with the quality of business continuity plans in all deal sizes. A plan should not just say "in the event of an incident we will all work from home and everyone knows what they should be doing" – that's clearly not robust enough and, whilst that might be exactly what happens, it doesn't meet the FCA's expectations.

From a buyer's perspective, ensuring the target has a robust business continuity plan (BCP) should feature high on the list of due diligence concerns. Depending on how the deal is structured, there may be a period of time, post-acquisition, where the target continues to operate autonomously before being incorporated into a wider group structure. During this period, should an incident occur that requires the activation of the BCP in order to continue servicing consumers, it is not the time you want to find out that the target doesn't have all its ducks in a row. This is not the only risk associated with poor continuity planning. A well-documented BCP should include anything that poses a risk to the continuity of business – including key personnel whose absence could result in critical functions not working as they should, or who might be a flight risk – it's particularly important to identify this as a period of significant change is about to get underway.

Good governance around business continuity doesn't have to cost the earth, and should always be proportionate to the size and scale of the firm's activities, but not having it in place when you need it will almost certainly prove to be a costly oversight for all involved.

Complaints

Another common theme we see is an empty complaints register. Whilst a target may think they look more appealing to a potential buyer if they can say "oh, we don't get complaints", this is almost certainly the result of a lack of understanding around what constitutes a complaint, how they should be handled and how they are perceived by others.

Everybody gets complaints and, from a buyer's perspective, finding a firm has a busy complaints register doesn't necessarily mean that there is an issue with that firm. It could be quite the opposite, as complaints give the firm an opportunity to learn and improve their offering, and to develop better systems, processes and policies that ultimately lead to better outcomes for their clients.

In some extreme cases there might be a systemic issue that means the deal is a non-starter (such as historic DB advice issues as covered earlier) but in most cases a buyer should be considering how the firm dealt with the issues and what they did to ensure it didn't happen again. Seeing a complaints handling policy that doesn't focus of "how can we make this go away and quickly" but instead focuses on thorough root cause analysis and remediating the issues is a green flag from our perspective. With the introduction of the Consumer Duty, identifying issues and rectifying them to improve consumer outcomes and reduce the risk of harm should be at the forefront of a firm's thought process and an empty complaints register should be viewed as unrealistic and a potential red flag.

Anti-Financial Crime controls and a firm's obligations

Every regulated firm has an obligation to ensure that they have systems and controls in place to mitigate the risk of being used to further financial crime. A key component of this is carrying out a Business Wide Risk Assessment (BWRA). We have seen multiple examples of where targets have identified themselves as "low risk" without any justification or rationale for that decision.

Again, much like complaints, it may come down to the perception that being seen as low risk is more appealing. Realistically, all financial services firms face a risk of being used to further financial crime, regardless of the services they offer. Some are at more risk than others and in the wealth management space, stockbrokers aside, the risk is often deemed to be lower – but firms must be able to demonstrate how they came to that conclusion. The FCA continues to take Enforcement action and issue fines to firms for financial crime prevention failings, and many of these centre around not understanding the risk the firm faced. How do you understand the risk? By completing a BWRA.

Even a three-person IFA firm only offering its services to the local community should be completing a BWRA. Arguably, criminals are more likely to try to target smaller firms as they anticipate their controls being much weaker. Ensuring the target can demonstrate an understanding of the risks it faces and the steps it has taken to mitigate them is critical in the due diligence process.

PII Policies

The difficulty firms face in obtaining PII cover has been well publicised and understandably this has led to firms working hard with brokers to find a policy that is as cost effective as possible. We request and look to review a firm's PII policy in all of the due diligence we undertake. Given the scope for historic failings, wealth management firms must have in place the correct policy.

The key failings we see regularly are:

- Policies not meeting the excess requirements – policies must not make provision for payment by the firm of an excess on any claim of more than £5,000, unless the firm holds additional capital resources (IPRU-INV 13.1.25 R). For firms that carry out or carried out DB pension transfer advice it is not uncommon for the excess to be higher than £5,000. Buyers must ensure that where this is the case, the target has put aside the relevant amount of additional regulatory capital to cover the increase.
- Policies that don't cover business the firm has undertaken historically – all polices must account for the business a firm has undertaken in the past as the liability can exist almost indefinitely. If the policy doesn't account for this the target must be able to demonstrate correctly via its regulatory reporting that it has the liability insured by another policy or that it holds additional regulatory capital.
- Policies not complying with the requirements of IPRU-INV 13.1.20C R –

> "The policy's terms must include a statement confirming that the policy complies with IPRU (INV) 13.1.20AR."

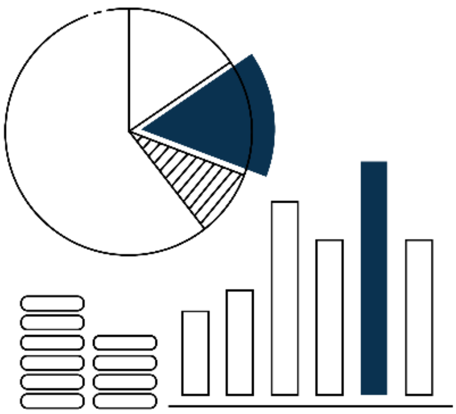
Whilst this may appear to be a very minor issue, the FCA expects that firms have reviewed their policies and are comfortable that they meet all of their requirements. Whilst the omission of the wording is unlikely to invalidate a policy if identified by the regulator, it demonstrates a lack of understanding of how their rules should be applied and could be indicative of a wider issue with systems and controls.

Lack of documented governance

Ok, we concede that this might be to many a very, very minor issue, but hear us out. Having a policy and process in place to enable compliance with the relevant regulation is only going to be effective if the content of that policy reflects the current regulation. Having systems in place to enable the review and amendment of policies and processes is critical to a firm remaining compliant.

We have seen documents that are recorded as having been written in 2016 with no evidence of any update or review since that time. So for that particular firm the assumption is that its documents haven't been updated since the implementation of, for example, MiFID II, the SM&CR, PRIIPs regulation, the Insurance Distribution Directive, GDPR, ESG and Sustainable Finance Regulations, Brexit and the Consumer Duty.

It's easy to see why, for a buyer, it's becoming very difficult to get comfortable with the systems and controls a target has in place – it raises all sorts of questions regarding historic compliance with those various regulatory initiatives and the potential need for remediation. A target should have in place a process for 'horizon scanning', again proportionate to the size and scope of the firm, to identify relevant changes to regulation that necessitate updates to policies and processes. Being able to evidence on these documents that they have been subject to review and amendment demonstrates good governance. Even if a target somehow managed to miss all of those previous regulatory initiatives, being able to evidence that policies and processes have been reviewed through the lens of the Consumer Duty is key to being able to evidence compliance.



A lack of policies and processes or key information

This one is much more of an issue with smaller targets where much of the information is known to employees and hasn't been documented. This poses a real risk to the buyer. In simple terms, post-acquisition there may be a level of staff turnover that means most of that knowledge and information disappears out of the door. In a regulatory context the rule of "if it's not written down, it didn't happen" should be applied. Policies and processes are how a firm demonstrates the strength of its systems and controls. Not having a basic policy framework in place, or leaving out elements of policies, can easily lead to a breach of the regulations. One of the most common findings we come across is not detailing how things are reported or escalated within the target firm. In a small firm environment this is likely to be that it's shouted across the room to the relevant person but the reporting and escalation process must be documented and is expected by the regulator.

Implementing the Consumer Duty

This one is relatively new to our due diligence reviews but as the FCA's work progresses with assessing implementation and how the Consumer Duty is being embedded into firms, it is becoming more and more relevant on the list of due diligence concerns for buyers. This isn't as simple as reviewing a target's fair value assessments or its Consumer Duty project and policy – it's about identifying how they have sought to embed and consider the Consumer Duty in all aspects of their business. We are yet to identify any real issues in this area given its infancy but areas for consideration and thought as part of regulatory due diligence are:

- Recruitment process and remuneration – firms put an enormous amount of time and effort into meeting the four outcomes. The real challenge for them now is how to embed the Consumer Duty into the culture of the firm and that starts with recruitment and remuneration;
- Business planning – firms must ensure that the Consumer Duty features at every stage of their business planning, be that the next 6 months, 12 months or 5 years. Whilst a buyer will obviously want to see that the target has strong financials and growth projections these must all be looked at with consumer outcomes and reducing the risk of harm to consumers in mind;
- The annual board report – we expect to see firms making progress with this or at the very least to have considered what is required and by when, when maintaining their implementation plans. Firms that can't evidence that they are or have been making preparations or can't demonstrate an understanding of their obligations should be seen as a red flag.

Conclusion

We have been involved in some interesting and sometimes complex target acquisitions over the last year and look forward to seeing how this area develops, especially with the embedding of the Consumer Duty.

Firms on both sides of the potential acquisition have responsibilities when it comes to enabling a smooth transaction, and the onus is on the buyer to ensure they ask the right questions before they make any legally binding decision or commit to anything.

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Personal Pensions Update

2023 saw the beginning of big changes in the defined contribution pensions market. But are providers ready?

Introduction

With UK defined contribution pension schemes on track to reach £1 trillion assets under management by 2030 and we see the first generation of entirely defined contribution pension savers begin to reach retirement, the UK Government, regulators and pension savers are turning their focus to pension savings.

It is becoming increasingly clear that saving the automatic-enrolment minimum of 8% of qualifying earnings, into a qualifying pension scheme where the focus is on low annual management charges and, as a result low returns, is simply not going to be sufficient for many people to retire. There is also a question over whether savers who are 20 or 30 years away from being able to drawdown their pension pots really need the level of liquidity currently common in the pensions market.

The Government and many commentators are looking to other jurisdictions such as Australia and Canada where including less liquid assets as part of a diversified portfolio is often cited as providing better loss adjusted returns. We are also seeing increased awareness among pension savers of where their pensions are invested and whether those investments reflect their values from an ESG perspective. With this in mind, we are seeing pension savers looking at how they can maximise their pension investments in order to have the retirement they are aspiring to.

In the autumn statement, the Chancellor outlined plans for a "pot follows member" approach to pensions. Under these proposals, employees will be able to nominate their own pension fund for employers to make contributions. He also added further colour to the Productive Finance initiative, under which there is a hope that pension funds will start investing in the UK economy by way of less liquid assets through the new Long-Term Asset Funds (LTAFs) and Long-Term Investment For Technology and Science (LIFTS).

It is perhaps unsurprising against this backdrop that defined contribution pensions, and in particular SIPPs, appear to be both increasing in popularity but also in regulatory scrutiny. In this article, we look at some of the areas of focus in the SIPP market.

Governance

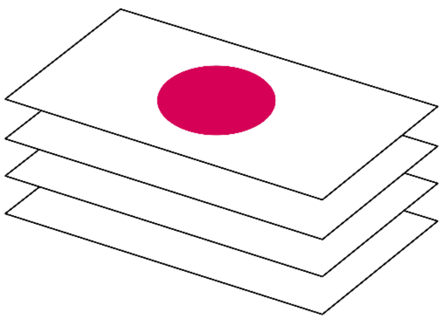
The SIPP market is extensive and the level of governance in providers varies immensely. Over recent years, there have been a number of high profile takeovers of SIPP providers as well as certain providers failing.

Whilst many SIPP providers are run well, common with the wider pensions industry we have seen that governance, systems and processes are often surprisingly inadequate. This is something that was highlighted in the FCA's "Dear CEO letter" issued last spring.

Over the last year, both the Pensions Regulator and the FCA have increased their focus on member outcomes. Examples of this include the FCA's Consumer Duty and the introduction of cash warnings and default funds for new, non-advised pension savers in personal pension funds including SIPPs in December 2023.

These requirements introduce increasing governance burdens on providers and this is set to continue. In our experience, many providers have grown in a piecemeal fashion and often experience challenges including: (i) systems not being maintained or integrated where businesses have been taken over; (ii) poor record keeping; (iii) systems not being built to flag key dates or events relevant to client SIPPs such as the need for rent reviews over commercial property or holding excessive cash; and (iv) skills and knowledge within the workforce.

We have considered some key areas below which highlight the significance of governance on both consumer outcomes and provider performance.



Assets

For many pension savers, a key appeal of SIPPs is the diverse investable asset range. We know that such investments (if properly 'diligenced' and managed) can produce impressive loss adjusted returns over a longer term time horizon. This is, of course, what many pension savers are banking on.

The challenges associated with such investments are nothing new. For some providers still prepared to hold less liquid assets, we regularly see significant governance failings including: (i) missing or incomplete documents; (ii) failures to get valuations; and (iii) a lack of knowledge and understanding around maintenance and ongoing liabilities. Linked to this, we have also seen mis-selling claims, for example in relation to store pods, which for many have all but completely lost their value over a short space of time.

The reality is, illiquid assets are often messy and expensive to manage. It is perhaps for this reason that many SIPP providers limit the assets they are prepared to hold to being a majority liquids. However, there is a real question over whether such an approach is sustainable in the long run.

In 2023, the Productive Finance initiative and the introduction of cash warnings (driven by concerns about over 10 million Brits holding more than £10,000 of their investable assets in cash) are driving a shift towards less liquid assets across the pensions industry. This shift is arguably supported by a move away from annual management charges and the introduction of performance-based fees being permitted in auto-enrolment schemes in Spring 2023 and the FCA's focus on value for money. Whilst these changes are welcomed by many and should no doubt result in better consumer outcomes, they will also significantly add to the governance burden of providers.

To the extent that we see a meaningful move towards less liquid assets, care will need to be taken when designing, implementing and maintaining governance processes to manage this.

Consolidation

The entirety of the wealth management sector is consolidating and the SIPP market is no exception.

Having worked with a number of SIPP operators who have grown by acquisition, we have observed the challenges with on-boarding and integrating the acquired businesses.

Whilst there is no 'one size fits all' approach to governance and integration, we have the following observations based on recent experiences:

- **Proper due diligence over the target book is key** - in particular, making sure scheme and asset ownership documentation is available. We have seen many cases where providers have acquired a book but do not have all necessary documentation relating to the assets or the scheme. Missing or incomplete documents can cause significant problems including the inability to trade or realise assets. There can also be tax and land registry implications. It is not uncommon for problems associated with documentation to cost a disproportionate amount of time and money to resolve.
- **Registrations and service details** - we have seen many cases where details of the new operator have not been updated with relevant authorities, such as HM Land Registry. This can cause significant issues down the line including, in extreme cases, missed court orders and petitions for winding-up.
- **Systems and processes** - we know that integrating systems and processes is easier said than done. However, providers would be well advised to create an integration plan following any acquisition. We often see that inherited, legacy systems are not properly maintained following an acquisition. This can often result in performance failings and the risk of losing vital customer information. There is also a risk that inherited systems will only be understood by legacy staff and, as staff turnover occurs, institutional knowledge depletes.

What's on the horizon?

In recent months and in line with a broader regulatory focus on governance, we have seen the FCA take a greater interest in the way SIPP businesses are being run and being much more involved in consolidation events. We anticipate that this trend will continue.

We also anticipate the debate around liquidity and evolution of value for money considerations will continue. If managed properly, these areas could present big opportunities for providers and investment managers.

No matter how the industry evolves, good governance will be key to managing the related risks and capitalising on the opportunities the shifting pensions landscape presents. With that in mind, investing in governance in 2024 will be a 'no regret action' which could result in operational efficiencies, meaning better consumer outcomes and better profitability for providers.

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Financial Promotions – gateways and gaps

2023 witnessed further efforts by the FCA to enhance the FinProms regime by filling gaps and creating a gateway for approvals

The FCA has introduced a new gateway for firms that approve financial promotions (see PS23/13). Additionally, it launched a consultation seeking industry engagement on measures to address regulatory gaps arising from the increasing use of new forms of social media to communicate financial promotions.

As part of its continuing attempts to 'close the stable door', the FCA has also introduced financial promotion frameworks applying specifically to cryptoassets.

PS23/13 Gateway for Approving Financial Promotions

It has previously been possible for authorised firms to approve an unauthorised firm's financial promotions, solely on the basis that the authorised firm is satisfied that the promotion will not breach any regulatory requirements, including the requirement that the promotion is 'clear, fair and not misleading'.

In September, the FCA's policy statement changed this to require any authorised firm wishing to approve financial promotions on behalf of an unauthorised firm to now pass through a new 'regulatory gateway' in which it must apply to the FCA for permission to do so. The FCA believes this will allow it to assess a firm's suitability to approve financial promotions and more effectively monitor the approvals carried out.

The FCA also considers that this process will support the implementation of the Consumer Duty through ensuring promotions provide consumers with sufficient understanding of the products and services being advertised as well as the risks involved. This will enable consumers to take greater responsibility for their decisions through improved understanding of what they are offered and prevent potential consumer harms.

The new gateway is created through an amendment to section 21 of FSMA requiring all authorised persons approving financial promotions to apply to the FCA for permission (as an "approver" under s.21 FSMA). These new rules will come into force on 7 February.

However, there are exemptions set out by the Treasury in the Financial Services and Markets Act (Exemptions from Financial Promotion General Requirement) Regulations 2023, which remove certain authorised firms approving financial promotions from being subject to the new 'approver permission' gateway.

These are:

- financial promotions prepared by a principal firm's ARs where the promotion relates to a regulated activity for which the principal has agreed to accept responsibility;
- financial promotions prepared by unauthorised persons within the same corporate group; and
- their own promotions (for communication by unauthorised persons).

In addition to the regulatory gateway, further reporting requirements were introduced by the FCA applying to firms that approve financial promotions.

Consistent with the FCA's focus on promotions of high risk investments targeted at retail investors (including cryptoassets), if a promotion relates to a product which is the subject of a retail mass marketing ban or is a qualifying cryptoasset investment, the authorised firm must notify the FCA within 7 days of approval of that promotion. Similarly, firms must notify the FCA where they approve amendments to a promotion or where they withdraw approval if this is due to a 'notifiable concern'.

In order to enhance the FCA's monitoring of the approvals market, approvers of financial promotions will also be subject to a biannual reporting requirement. Approver firms will be required twice each year to submit data to the FCA about the promotions that they approve. This data must include each firm's total approved promotions in the relevant period, broken down by the types of products being promoted and any 'marketing restriction' categories that apply to the promoted products.

GC23/2 Financial Promotions on Social Media

The FCA recognised that rapid changes in the way social media is used and widespread popularity of new social media platforms have created gaps in the existing framework applying to financial promotions on social media.

The previous framework was largely set out in FG15/4 published way back (in tech time) in 2015. Although these rules were introduced (in relative terms) not long ago, the fast changing ways in which communications are made online has allowed new forms of promotions to be made which have the potential to cause significant consumer harm. This has come through regulated firms seeking to capitalise on the popularity of new social media platforms to advertise their services, as well as the rise of financial influencers (often called 'finfluencers') who gain audiences through offering financial tips and recommendations. As a result, the FCA launched a guidance consultation (GC23/2) in July.

Within this consultation, the FCA set out its proposals to ensure firms understand the FCA's expectations for FinProms, including that they should be 'fair, clear and not misleading'. The FCA also emphasises that unauthorised persons promoting financial products on social media may be committing a breach of the financial promotions restriction in section 21 of FSMA and, therefore, an offence. Additionally, the FCA noted that the Consumer Duty creates greater expectations for firms communicating or approving financial promotions to deliver good outcomes for retail customers. This should be considered alongside the proposals set out by the FCA.

The consultation identifies difficulties arising from promoting certain products in a compliant manner on social media. The character-limited nature of some social media platforms makes them inherently unsuitable as a vehicle for the promotion of complex products. The requirement to be 'fair clear and not misleading' and the obligation for firms to enable customers to make good decisions under the Consumer Duty means that customers must be informed of both the potential benefits and risks associated with products. Achieving this using a character-limited format is likely to be difficult.

This analysis must be considered by firms on a product-by-product basis. The guidance consultation highlights that some products may be inappropriate for promotion on social media entirely, due to the amount of information required to adequately explain the complexity of the product.

However, when the financial promotion is limited by size, the consultation does recognise it may be possible in some cases to signpost such a product or service and provide a link to more comprehensive information, provided that the promotion remains 'standalone compliant'. Alternatively, it may be appropriate to use 'image advertising' to promote a firm generally.

The consultation also reminds firms that promotions for certain products are required to include risk warnings or other statements. These requirements apply equally to promotions on social media and are expected to be clear and sufficiently prominent without the use of any design feature that may reduce their visibility. Under the new proposals, firms are advised to ensure risk warnings and important information are not obscured as well as to consider the specific design features or relevant social media platforms such as 'truncated text' (where some of the text is obscured by an ellipsis such as 'see more…'). Firms must ensure that risk warnings are not obscured by the ellipses and are clear on the face of the promotion. If it is not possible to avoid this, firms should ensure as much of the warning or information as possible is displayed.

Additionally, the FCA highlighted its previous occupational paper (OP/26) on behavioural research, which showed that risk warnings are more effective when viewed at the time or just before the communication of the promotion, as well as when they are prominent and stand out from their surroundings. For this reason, the FCA advises that consumer understanding may be limited when risk warnings are less prominent than the headline or provided at a later stage.

The FCA specifically identified the growing presence of influencers operating on social media that engage in communicating financial promotions. These include:

- celebrity influencers with large followings. Although not usually associated with financial services, such persons may be compensated for the use of their digital presence to promote companies with a business interest in people making certain financial decisions;
- 'finfluencers' - usually aren't authorised by the FCA to provide financial advice but share their opinions on financial products and recommendations. Such advice is identified by the FCA as potentially misleading; and
- forums or discussion groups on financial topics. These may be public or private groups where participants exchange information and share knowledge. In some cases, these groups are set up to encourage participants to register for financial courses or sell financial advice or other products outside of the forum.

The FCA considers that these communications have the potential to cause harm regardless of the size of an influencer's following. In response, the FCA has created an infographic with the Advertising Standards Authority that highlights to influencers when they might be at risk of promoting financial services illegally, and encourages them to consider if they are the right person to make the relevant promotion.

Cryptoasset promotions

Via policy statement PS23/6 and finalised guidance FG23/3, the FCA has updated the framework for the promotion of qualifying cryptoassets and related services. Qualifying cryptoassets are broadly defined to capture any cryptographically secured digital representation of value or contractual rights that are transferable and fungible. These publications create new rules and guidance covering the application of FCA rules on cryptoasset financial promotions (including guidance for promotions on social media as described above), due diligence required before communicating cryptoasset promotions and disclosing legal and beneficial ownership.

This new framework is designed to enhance consumer protection in the (as yet) largely unregulated cryptoasset industry by creating greater transparency and awareness of the products and services consumers are engaging with and the risks involved. Nevertheless, the FCA highlights that they continue to believe that cryptoassets are high risk investments and that consumers should understand they may lose all the money they invest.

In this context, the updates introduced last year have been made with the overarching goal of protecting consumers, including by categorising cryptoassets as 'restricted mass market investments'. In doing so, all the associated restrictions on how such investments can be marketed to consumers will apply to them.

Conclusion

As we have highlighted in our previous annual reviews, the FCA continues to take a pro-active approach to the regulation of financial promotions and is taking action where firms may not be acting in the consumers' best interest, or there is a risk of consumer harm.

This includes updating its rules and reminding firms of its expectations as new technologies change the way in which financial promotions are made, as well as where new products such as cryptoassets are advertised to consumers as alternative investments. This is alongside the introduction of greater protections within the financial promotions framework, including ensuring those approving financial promotions are fit to do so and do so responsibly.

These updates have been introduced to ensure that financial promotions remain clear, fair and not misleading, as has always been required, despite changes in consumer habits and technologies.

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IFPR – two years in…

In the ever-evolving landscape of financial regulations, the UK Investment Firm Prudential Regime (IFPR) emerged as a pivotal framework for the reshaping of prudential standards for MiFID investment firms. Effective since 1 January 2022, the IFPR encompasses entities ranging from fund and asset managers to broking and trading firms, custodians and depositaries, and investment platforms

Understanding the IFPR

The IFPR was designed to streamline and simplify prudential requirements for MiFID investment firms regulated by the FCA in the UK. It represented a significant shift by extending the focus beyond risks to include the potential harm that a firm may inflict on consumers and markets.

At its core, the IFPR mandates that firms hold sufficient financial resources to support ongoing activities and facilitate an orderly wind-down, as prescribed by the Overall Financial Adequacy Rule (OFAR).

The linchpin of the IFPR is the Internal Capital Adequacy and Risk Assessment (ICARA) process, a comprehensive assessment aimed at ensuring compliance with the OFAR. This process should bring together business model analysis, stress-testing, recovery planning, and wind-down planning. The key word here was always 'process'; this wasn't just to be a report to replace a firm's Internal Capital Adequacy Assessment Process (ICAAP) – it was always intended to be living, breathing and adapting to the environment in which the firm operates.

Scope of the Multi-Firm Review

Firstly, we have to acknowledge the complexities surrounding the implementation of the IFPR. It brought many firms into scope of prudential regulation who had previously been excluded. Whilst the number of categories that a firm could fall into was simplified, the new requirements placed on firms were considered onerous by many.

As with all regulatory initiatives, the FCA waits patiently before shining the light on the industry's adaptation to a new regime. The waiting period is now over and the FCA has conducted a multi-firm review.

This review was intended to gauge the progress of firms in embracing the IFPR, with a specific focus on the ICARA process and its associated components. As part of this endeavour, the FCA has recently published its final report, providing its insights and initial observations, aiming to assist firms in understanding the requirements and refining their processes.

What did the FCA find?

Lack of Adequate Assessments within Investment Firm Groups

You may remember that the group capital test was a source of much debate in the run up to implementation and many investment firm groups opted for a 'group ICARA' process. The FCA's review identified a shortfall in the assessment of individual firm risks within these groups. Consolidated assessments often lack consideration of firm-specific risks and harms, potentially compromising the resilience of individual firms.

We encourage investment firm groups to enhance their 'group ICARA' processes by comprehensively considering risks at the individual firm level. This is particularly relevant if you've been busy with your M&A activity. Understanding the contingent liabilities of acquired firms that sit within the group is vital, particularly if they continue to service their own client base.

Inconsistent and Incomplete ICARA Process Assessments

The FCA observed a lack of cohesion and integration within the ICARA process, indicating that some firms failed to adequately assess risks. This has led to inappropriate mitigation measures and an insufficient understanding of the potential harms stemming from their operations.

We would always advocate for a more holistic and integrated ICARA process within firms. This involves fostering a culture where risk assessments are not standalone activities but are seamlessly integrated into the firm's overall approach to managing financial resources.

Risk management frameworks (RMF) should run alongside the ICARA process and feed into it where necessary. If we consider people risk, whilst an investment manager leaving unexpectedly may seem like an unrelated risk in the RMF, once crystallised it starts off a chain of events that could lead to a mass withdrawal of funds. This puts real stress on the firm's finances as it struggles to meet its liabilities. It is a dramatic example but understanding what steps the firm has in place to mitigate risks of this nature can help ensure that the relevant financial provision is there should the mitigation strategy not play out as expected. Developing frameworks that align risk assessments with the mitigation measures and financial resource allocation will enhance the overall effectiveness of the ICARA process.

Weaknesses in Wind-Down Planning

The assessment of wind-down planning exhibited weaknesses in scope, quantification, and integration with the ICARA process. Unrealistic assumptions and poorly justified estimates of resources needed for an orderly wind-down were prevalent issues.

Firms should be looking to fortify their wind-down planning by considering stress scenarios, incorporating group membership considerations, and ensuring comprehensive analyses.

Please don't pluck figures and timescales out of thin air, though. We share the FCA's observation – all too often we see "It'll take us 3 months and cost £25,000 to wind down our business serving 10,000 clients invested in an array of different investments, from different providers, with the monthly fixed overhead cost of running our business and servicing our clients of £100 per client".

It is very obviously not going to take 3 months and is going to cost substantially more than £25,000. Nobody likes to think about the firm failing and we appreciate that but if you are going to plan for the worst, there should be comprehensive analyses of wind-down requirements, ensuring that assumptions are realistic and resources are adequately estimated. Stress-testing wind-down plans against various scenarios, including reverse stress tests, can enhance their credibility

Inaccurate Data Submission in Regulatory Reports

The FCA highlighted instances of inaccurate and incomplete data submissions in regulatory reports, underscoring the importance of data accuracy as an indicator of systems and controls weaknesses.

We cannot stress enough the significance of accurate data submission. Firms should be aligning regulatory reports with the ICARA, annual accounts, and management information. Any discrepancies can and will be looked at and once that box is open, it can take time, money and significant effort to get it closed again.

Reporting is not a last minute activity, and firms should be well aware of their reporting schedule in advance and if you aren't – or feel something isn't right – take steps to make yourself comfortable with what is expected.

Collaboration is key when it comes to accurate regulatory reporting. If pressing the 'submit' button is your responsibility, you should ensure you have all the input and approval from all parties who are involved a sensible amount of time before your submission deadline. Firms should have in place proper systems and controls to ensure that reporting is compiled, reviewed and approved in a timely and efficient manner.

Conclusion

As the IFPR journey continues, the FCA's observations give a valuable insight and provide an opportunity for firms to foster a culture of continuous improvement within their organisation.

By addressing identified shortcomings and actively seeking ways to enhance processes, firms can not only comply with IFPR but they can also strengthen their overall risk management frameworks.

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Financial Crime priorities for Wealth Managers

Financial Crime prevention continues to be at the forefront of the regulator's agenda and there is no suggestion of this abating in 2024.

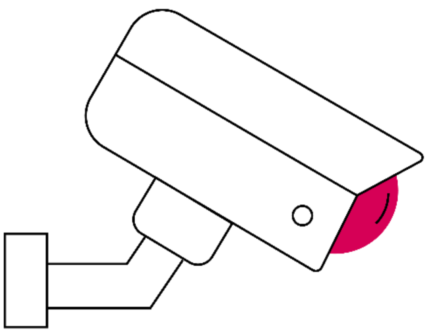
Introduction

The regulator's areas of focus have been widely trailed in terms of where it sees the greatest likelihood of harm arising and it is presently consulting on what the priority of those areas will be in 2024. Notably, the FCA publications in late 2023 signposted a number of key areas of concern through publications of cross-sector reviews on Sanctions, Domestic PEPs and Financial Crime Prevention and Consumer Duty expectation in a Dear CEO Letter to the Wealth Management and Stockbroking sector.

These were expanded upon and discussed more widely when we attended the FCA's Financial Crime Consultancy Forum at the end of November. During the session, the FCA signposted that its approach to supervision will continue to be targeted, intrusive and assertive – including wider use of 'short notice' and 'unannounced visits'. With this in mind, we expect to see an uptick in the level of data requests and supervisory engagement with firms and, as a result, a greater number of Skilled Person reports commissioned in relation to Financial Crime.

As Financial Crime is ever-evolving, firms need to ensure their systems and controls are fit for purpose and dynamic in order to maintain pace with the financial crime risks that the firms face and short-notice visits will permit less 'road-side' remediation of processes by firms in advance of fulfilling information requests, as has sometimes been the case in recent years.

So we suggest that early in 2024 you ask yourselves the question, 'if the FCA arrived tomorrow, would you be ready?'



Sanctions

In the Forum that we attended, sanctions compliance was a major talking point. The FCA shared its supervisory approach relating to sanctions compliance, covering; Engagement, Testing, Reacting and Remediating. Shortcomings by firms were set out in the Dear CEO letter that was based upon a thematic review, which employed the FCA's four-pronged approach and will now be rolled out more widely. It was also indicated that focus will be directed towards firms' CDD/KYC, risk assessments, screening capabilities, list and alert management and reporting of breaches. Firms should review our summary of the recent thematic review on sanctions systems and look to strengthen controls, where necessary, to not only be ahead of FCA supervisory activity, but to truly ensure that every business is responsibly managing the risk of dealing with Designated Individuals flagged on sanctions lists.

PEPS

As required under legislation, the FCA is undertaking a periodic review of its approach towards the classification and treatment of Politically Exposed Persons (PEPs). The FCA's 'PEP review' is looking at the issues the FCA highlighted and firms' arrangements for dealing with PEPs including, but not limited to, how firms are conducting proportionate risk assessments, applying enhanced due diligence and ongoing monitoring. The review will report by the end of June 2024, which may in turn see new regulation come into force and revisions to the FCA's Financial Crime Guide. While the outcome of the review is still some months away, it could be material later in 2024. However, the key take-away from the Financial Crime Consultancy Forum was an overwhelming swell of opinion from FCA supervision teams and from consultants alike, that firms do not understand the current UK PEP rules and many do not currently apply them as intended.

The FCA's review will place a lens on firms' arrangements for dealing with UK-based PEPs, including approaches towards:

- applying the definition of PEPs to individuals;
- risk assessments of UK PEPs, their family members and known close associates;
- the application of enhanced due diligence and ongoing monitoring;

- decisions on whether to reject or close accounts for PEPs, their family members and known close associates;
- communication with PEPs; and
- the ongoing review of the PEP controls firms have in place to ensure they remain appropriate.

This area is certainly worthy of some self-review in 2024 and a commitment by firms to keep a watching brief as to how this area develops this year.

General Messages

In our publication, we also distilled the key messages from the Dear CEO letter to the sector. This set out FCA expectations of firms to counter Financial Crime, including:

- preventing Fraud scams;
- understanding Financial Crime Risks;
- having robust Systems and Controls;
- having appropriately experienced and independent SMF 16/17 Holders;
- sharing information and reporting SAR/STOR concerns; and
- implementing the FCA's Financial Crime Guide (FCG).

Conclusion

Firstly, it's important to understand the FCA's view of the wealth management sector; its scale and the level of assets under management/influence, combined with the number of retail customers it serves, makes this sector one of the higher risk sectors in Financial Services. Moreover, it's seen as inherently high risk for enabling or participating in Financial Crime through firms facilitating scams or laundering assets for illegitimate clients, which in turn has a damaging impact on consumers, markets and the wider society, while harming the reputation and long-term profitability of the industry and sector.

Next, firms and senior management should not only understand the risks inherent to their business, but also the risk mitigants that have been put in place in order to address them before they are able to crystallise, and their ongoing effectiveness. We still see many firms who have not undertaken a Business Wide Risk Assessment, which is the foundation of Financial Crime prevention.

Lastly, firms should ensure they are aware of and well-versed in the recent thematic reviews undertaken by the FCA and pay close attention to the 'Next Steps'. Where there is a thematic review currently being undertaken, firms should carry out a proactive self-assessment, or engage with third-parties to determine if there is any impact on the firm and stay ahead of any supervisory activity. Internal Audit review and challenge across each line of defence is also a vital part of looking at a firm's entire Financial Crime prevention framework.

Evidence suggests that the FCA will continue to become more strident in how it delivers its 'targeted' 'intrusive' and 'assertive' supervision strategy, and early planning and focus on Financial Crime risk across this year will mean that your firm doesn't end up becoming one of the statistics in its Skilled Person reports commissioned or tables of fines issued.

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Sanctions – Wealth Managers must play their part

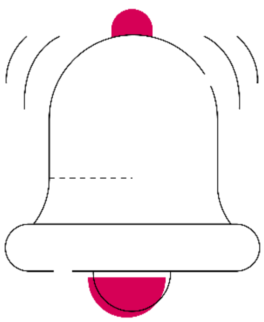
In the wake of Russia's invasion of Ukraine, the UK (together with international partners) introduced a vast array of sanctions in an attempt to deter Russia. As a result, it is paramount that firms have robust and dynamic systems and controls in place to prevent a breach or suspected breach of the UK Sanctions regime and applicable regulatory requirements.

Regulatory Landscape

The Office of Financial Sanctions Implementation (OFSI), which is part of HM Treasury, is responsible for improving the understanding, implementation and enforcement of financial sanctions in the UK. OFSI is also responsible for monitoring compliance with financial sanctions and for assessing suspected breaches. It has the power to impose monetary penalties for breaches of financial sanctions and to refer cases to law enforcement agencies for investigation and potential prosecution.

The FCA is responsible for the supervision of regulated firms to ensure they have adequate and proportionate systems and controls in place to mitigate the risk of breaching the sanctions regime.

The Russia (Sanctions) (EU Exit) Regulations 2019 impose financial, trade, transport and immigration sanctions on Russia. Throughout 2023, the FCA has continued to intensify its regulatory engagement with firms, which sees around 10,000 firms and professional bodies receive written communication from the FCA, as well as publishing information on its website. Other actions taken by the FCA include liaising with the UK Government about sanctions design and implementation, developing and sharing intelligence and the introduction of its dedicated sanctions reporting tool.



Wealth management firms should read and appropriately apply SYSC, to understand their responsibilities under the MLRs and the expectation of compliance with all UK regimes under the Sanctions and Anti-Money Laundering Act 2018 (SAMLA). Furthermore, they should consider guidance that is available with regard to sanctions, such as the FCA's Financial Crime Guide (FCG), the Joint Money Laundering Steering Group (JMLSG) and the General guidance for financial sanctions under SAMLA (OFSI UK Financial Sanctions: General guidance).

Recently, we have seen the introduction of the Office of Trade Sanctions Implementation (OTSI) that is likely to strengthen enforcement and clamp down on companies who are not complying with Russian sanctions rules – more information can be found here.

Key messages for the Wealth Management Sector

The wealth management sector was placed under the spotlight in 2023, which saw firms receive a Dear CEO Letter in November, highlighting the FCA's concerns. We expect to see a continuation of similar engagement with the sector throughout 2024, in light of the publication on the FCA's Sanctions Systems and Control Review in September 2023, where the FCA set out the next steps which it expects firms to take. As a result, wealth management firms should be advanced in their evaluation of their approach to identifying and assessing the sanctions risk they are exposed to, taking into consideration the FCA's findings.

Given the well-publicised shift in the FCA's supervisory approach, to focus its supervisory efforts on the bad actors in the sector, wealth management firms should be paying close attention to the ever-evolving nature of the sanctions regime and the UK Sanctions List. This should act as a stark warning for firms to be actively reviewing and assessing their sanctions framework to ensure that, in the event the FCA drops by on a 'short notice' visit, the firm is well positioned to demonstrate the effectiveness of its systems and controls.

The wealth management sector should also be cognisant of the regulatory requirements under Regulation 16 of The Russia (Sanctions) (EU Exit) Regulations 2019. Firms should be clear with regard to dealing with transferable securities or money market instruments, namely the meaning of 'dealing with' or 'investment services' to ensure they do not fall foul of the regulatory requirement. Equally, the sector should be promptly engaging and reporting to the FCA / OFSI where a Designated Person or breach of the sanctions regulation (including a suspected breach) has been identified.

Thematic reviews

In September, the FCA published its findings from its assessment of sanctions systems and controls where it outlined examples of both good and bad practice under 5 key themes: governance and oversight, skills and resources, screening capabilities, CDD & KYC procedures, and reporting of breaches to the FCA. As wealth management services in the UK are provided to high net worth individuals from, or with links to, higher risk jurisdictions, firms should be paying close attention to their sanctions systems and controls, ensuring they are 'fit for purpose' and effective in managing the risk of directly or indirectly dealing with a 'Designated Person'.

Our recent article explores the thematic review, highlights the key messages and findings, and explains how DWF can support you in ensuring you don't fall foul of the UK Sanctions regime.

Cost of sanctions

The cost of staying compliant with the ever-evolving UK sanctions regime continues to be high for firms operating in this sector, both in resource and financially. Given the non-negotiable stance of complying with the UK Sanctions regime, firms should be continually investing in systems and controls so they are able to meet the requirements.

Conclusion

With the well-publicised nature of the FCA's expectation for wealth management firms, those operating in this sector should be ready to accommodate a 'short-notice' or 'unannounced' visit from the FCA and an increased use of its supervisory tools and powers including use of its Sanctions Screening Tool (SST). Those responsible should be clear on how effective the firm's systems and controls are to ensure a Designated Person is identified immediately and any external reporting required is done without any undue delay.

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New AR Regime – one year on

In recent years there have been some high profile failures within the AR regime, which have ultimately resulted in harm to consumers and to the wider reputation of the financial services industry. This caused the FCA, along with HM Treasury, to consider whether the regime was working as it should.

Introduction

Most notably, the FCA was concerned that principal firms were not carrying out appropriate due diligence before appointing ARs; once appointed, principal firms were not conducting the expected level of oversight and monitoring of the activities of ARs; and the FCA questioned whether principal firms were holding adequate capital and liquidity to mitigate any risks arising within their business.

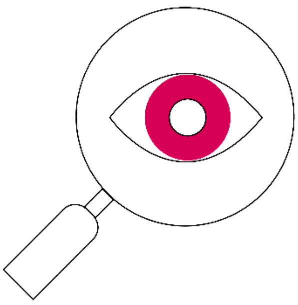
Firms seeking authorisation go through a rigorous application process and provide detailed information about every aspect of their business. Until recently, registering an AR was simply a matter of completing a form. That is not to say that the principal firms did not have obligations to conduct due diligence prior to on-boarding a new AR but without relevant data / information, it was difficult for the FCA to identify specific concerns and failures within the AR regime.

By way of illustration:

- in 2018 / 2019 principals and ARs accounted for 61% of the quantum of FSCS claims (the total was £1.1bn during this period);
- on average, principals generated 50% - 400% more supervisory cases and complaints than directly authorised firms; and
- supervisory cases were higher for principals across all sectors compared to those firms with no ARs.

It is not difficult to see why the regulatory spotlight fell on the AR regime.

It has been just over a year since the FCA's enhanced rules came into force (December 2022). Here, we examine the impact of the new rules and consider what steps principal firms should be taking to ensure they remain compliant.



Summary of key changes

The new rules and reporting obligations require principal firms to:

- carry out enhanced due diligence / on-boarding requirements before appointing ARs;
- conduct enhanced oversight and monitoring;
- complete an annual self-assessment demonstrating compliance with regulatory obligations as a principal;
- provide annual reports on complaints and revenue information for each AR, along with verifying the details of their ARs on an annual basis;
- notify the FCA of any changes to their ARs' activities or their business; and
- provide notification of planned AR appointments 30 calendar days before taking effect (at least 60 days if the principal firm will be a 'regulatory host').

A year on

The number of ARs, although still very considerable, has decreased since the introduction of the new regime by over 4,000 (as of September 2023). However, there are still around 2,900 principals with approximately 35,000 ARs reporting into them. Out of the 35,000, around 14,000 are Introducer ARs (IARs).

Even taking into account the 14,000 IARs, that leaves 21,000 ARs operating under the AR exemption. When you view these numbers in light of the fact that the total number of firms regulated by the FCA is approximately 45,000, it is understandable that the FCA might have some concerns about how this regime works in practice as it represents a very significant part of the financial services industry.

As part of the increased regulatory focus, the FCA has established a new AR department with a team of more than 30 staff committed to raising the supervisory standard. Reported actions to date include:

- Writing to more than 3,000 principal firms, reminding them about their obligations to properly oversee the behaviour and conduct of their ARs.
- In June 2023, the FCA reported that it had imposed restrictions on ten principals for failing to oversee their ARs.

- In the period 1 July to 31 August, the team's supervisory engagement resulted in the termination of over 1,300 ARs.
- Twelve firms have also agreed to the imposition of a voluntary requirement (VREQ) restricting how they carry out their business.
- In addition, the FCA reported that there have been many informal interventions.

With a number of principal firms choosing to withdraw from the regime, the FCA has received a number of applications for full authorisation from former AR firms. The FCA has reported that in the last year, 44% of new firm applications from former ARs were withdrawn or formally refused following assessment by the FCA, i.e., these firms did not meet the minimum standards expected by the FCA.

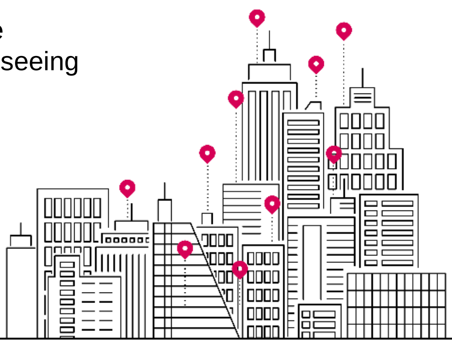
The FCA is continuing to analyse the information received about ARs and is using profiling tools and outlier analysis to focus resources on the riskier firms. From the FCA's perspective, the data has provided some valuable information, e.g. identifying principals who do not have dedicated resources for overseeing AR activities; and perhaps most notably, the identification of 60 principal firms that were acting as "regulatory hosts" which had not previously been notified to the FCA.

What Should Firms be doing?

Principal firms should be considering the following:

- On-boarding - robust due diligence: Principals should undertake robust due diligence of all new ARs and retain appropriate documentary evidence;
- Review AR agreements: contractual arrangements with ARs should be reviewed and updated where appropriate, e.g. to
    - ensure appropriate obligations are imposed on the AR to enable the principal firm to comply with the new rules;
    - take into account the Consumer Duty; and
    - include clear and defined termination rights for any non-compliance.
- Systems and controls: these should be sufficient to ensure that the principal firm is able to oversee and monitor the activities and business of its ARs to ensure that its ARs are acting in a manner that is compliant with the relevant regulatory requirements;
- Appropriate resources: again, these should be adequate in the context of managing and overseeing its ARs;
- Ongoing monitoring and assessment: principal firms should carry out regular assessments of their ARs, including
    - reviewing the fitness and propriety of senior managers;
    - the ARs' financial position;
    - the activities and business undertaken by the ARs; and
    - reviewing the adequacy of the systems and controls in place to ensure that the ARs are able to comply with the requirements of the regulatory regime.
- Identifying conflicts of interest: ensuring that the firm identifies any conflict of interests posed by the arrangements, particularly where there are arrangements whereby functions or tasks are delegated to an AR which would otherwise be carried out by the principal firm itself;
- Annual self-assessment: a "self-assessment" is undertaken at least annually of a firm's own compliance with its obligations as a principal firm. The self-assessment should be commensurate with the number of ARs reporting to the principal and the regulated activities undertaken;
- Senior management engagement: The self-assessment must be reviewed and signed off by the principal firm's governing body at least annually, which perhaps indicates how the FCA could be looking to hold specific individuals to account where failures are identified. The FCA has made it clear that it will look to this document to ascertain whether firms are properly ensuring that they remain able to oversee and monitor their ARs to the standard expected by the FCA;
- Collation and review of management information: senior management should ensure that it obtains and reviews relevant management information provided by its ARs to enable it to proactively identify any triggers which might give rise to a concern about the activities of its ARs, i.e.:
    - a sharp increase, or decline in an AR's business levels;
    - a rise in complaints; or
    - a change in the assets or liabilities for an AR that has previously conducted very little business.

Where triggers are identified, principals should investigate further and take action where appropriate.



Key areas of regulatory focus

The FCA is using data to focus on those areas that are likely to pose the greatest regulatory risk. High on its list of priorities over the coming year are likely to be networks and regulatory host arrangements.

The existence of a "network" (a principal firm with five or more ARs under its control) has always been subject to greater regulatory oversight and a clear marker for the FCA.

The term "regulatory host" has long been used, but was only formally defined as part of the new rules. A regulatory host is essentially a principal firm that carries out little or no regulated activities in its own right. Its sole purpose is to oversee the use of its permissions by its ARs. It is worth noting that the definition of regulatory host incorporates both group arrangements (i.e., where ARs are subsidiaries of the principal firm) and third party arrangements. This may be relevant to firms looking to expand their business through acquisitions of ARs.

There is now an enhanced regime in place for firms looking to act as regulatory hosts. Firms must notify the FCA of their intention to act as a regulatory host at least 60 days before doing so. The notification should be in the prescribed form (SUP 15 (Annex 4)). Regulatory hosts should also expect a higher degree of scrutiny and challenge by the FCA.

Conclusion and next steps

The FCA has clearly, and perhaps quite rightly, taken a firm approach with the AR regime. Its actions in the last 12 months demonstrate that it means business. That said, the number of firms that operate as ARs remains significant and the FCA is reliant on principal firms submitting timely and accurate information to enable it to identify higher risk arrangements and problems.

The AR regime remains a viable option for firms who understand their obligations and responsibilities as principal firms and have the appropriate resources available to enable them to comply with their regulatory obligations. There is clear evidence that the FCA is working with principals to bring them up to the standard expected by the FCA.

However, the FCA has said that it intends to continue to analyse the data and proactively seek out high-risk arrangements and outliers. Where it finds evidence of poor practices, the FCA has said that it will use all the regulatory tools at its disposal, including: imposing requirements; requiring skilled persons' reviews; and, where appropriate, Enforcement action. Since the introduction of the new rules, we have seen some evidence of the FCA flexing its regulatory muscles (in the form of VREQs and voluntary undertakings). However, at this stage action has been limited to the AR and authorisations teams. We anticipate that we might start to see some Enforcement cases coming through in the next 12 months.

HM Treasury has yet to report back to the industry on its Call for Evidence (published December 2021) which focused on the need for broader reform of the AR regime. As this was issued alongside the FCA's own consultation on the new rules, it may well be that HM Treasury is waiting to see whether the new rules resolve some of the issues identified before making any further decisions on changes to the regime as a whole. Perhaps more so than the FCA, HM Treasury is aware of the threat to the UK's reputation for competitive and innovative financial services offerings.

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ESG – mind the integrity gap

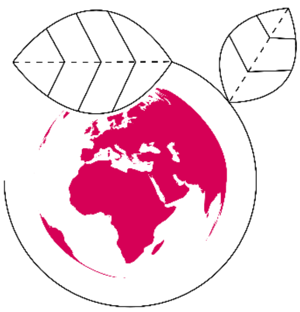
With increased emphasis on consistent, comparable and decision-useful ESG-related information, wealth managers need to keep abreast of the latest regulatory developments, voluntary standards and frameworks. In parallel, they will also need to mind the integrity gap – the disconnect between what they say and what they do – to mitigate the risk of greenwashing allegations and optimise business transformation opportunity.

Regulatory developments, consolidation and convergence within the international ESG frameworks and standards have continued at an unprecedented scale and pace. The wealth management sector can be seen as a beneficiary of these developments in its desire for the provision of consistent, comparable and decision-useful information to inform investment decisions.

International frameworks and standard setters

Several international frameworks and standard setters have come together under the umbrella of the International Sustainability Standards Board (ISSB) of the International Financial Reporting Standards (IFRS) Foundation. This includes the Sustainability Accounting Standards Board (SASB). The ISSB also builds on the work of the now sunset Climate Disclosure Standards Board (CDSB) and has issued its inaugural standards. IFRS S1 contains general requirements for the disclosure of sustainability-related financial information, and IFRS S2 covers climate-related disclosures. Both of these aim to create a common language for companies to communicate sustainability information to investors.

At the beginning of 2024, the ISSB also assumed responsibility for monitoring implementation progress of the G20 Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), a key framework for providing decision-useful climate-related financial information for investors. Over the past year, we have also seen the release of its sister framework on nature capital by the Task Force on Nature-related Financial Disclosures (TNFD). TNFD aligns with the four core elements of the TCFD of governance, strategy, risk management and metrics and targets and has brought heightened attention to the natural capital dimension of ESG. At the voluntary level this means we have seen not only consolidation but also convergence.



Mandatory disclosure requirements

Whilst we have had harmonisation and alignment on the frameworks and standards front, we have also witnessed further efforts to mandate disclosure of sustainability related information. In Europe, in particular, there has been a plethora of regulations, all of which are aimed at ensuring greater transparency of environment, social and governance (ESG) related information. Key pieces of European legislation include:

- The EU Sustainable Finance Disclosure Regulation (SFDR);
- The EU Corporate Sustainability Reporting Directive (CSRD); and
- The EU Corporate Sustainability Due Diligence Directive (CS3D).

SFDR came into force on 29 December 2019, requiring certain financial services firms to consider how sustainability risks are incorporated into investment decisions. It mandates specific disclosures on their websites, and contains detailed requirements on what must be disclosed to investors and on reporting frequency. Its effectiveness is currently being reviewed by the European Commission, with a report forthcoming, after two consultations closed in December. An area of focus in the consultation has been transparency and whether its disclosure requirements are consistent with those of the CSRD. Adopting an holistic view to optimise efficiencies across these different pieces of legislation is key.

The CSRD entered into force on 5 January 2023, replacing the previous Non-Financial Reporting Directive (NFRD). Its scope reaches an estimated 50,000 companies. The CSRD is complemented by a detailed set of recently published cross-cutting and topical standards: the EU sustainability reporting standards (ESRS). Like the TNFD these are aligned to four core elements of the TCFD; notably, governance, strategic, risk management, and metrics and targets. Importantly, there is also interoperability between the Global Reporting Initiative (GRI) standards and ESRS.

Again, we are seeing further coherence and harmonisation of ESG-related information.

The draft CS3D, provisionally agreed with the final text expected this year, requires organisations in scope to conduct due diligence to identify, assess, manage, prevent, mitigate or end adverse human rights and environmental impacts across its global value chain, including its own operations. It moves the emphasis beyond reporting to implementation, of which disclosure is only a part.

Your commitment to integrity

What do all of these increased efforts on the transparency of sustainability-related information mean for the wealth management sector? As a priority, wealth managers need to determine their commitment to transparency and integrity. They must be willing to be held to account for their own disclosures and implementation measures.

To discuss how you can capitalise on this key development and fully embrace sustainability in your transformational business strategy, please contact DWF's Sustainable Business and ESG Advisory Practice (ESG services | DWF Group).

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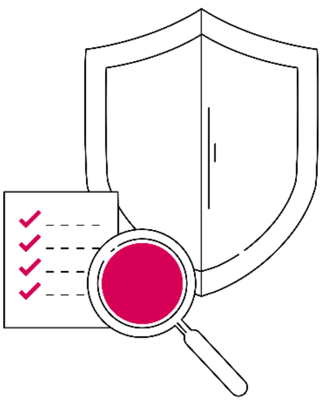
Capital Deductions for Redress – the potential implications for PII cover

In November, the FCA published CP 23/24 'Capital Deduction for Redress – Personal Investment Firms' (PIFs) setting out proposals to require PIFs to set aside capital for potential redress liabilities earlier. If PIFs do not hold enough capital to cover their potential redress liabilities, they will be required to retain assets until such time as they do.

The FCA says that the proposals are designed to require PIFs to be more "prudent", and to ensure that those firms which cause harm, or which have the potential to cause harm, to consumers will ultimately be in a position to meet any redress payable as a result of that harm – the 'polluter pays' principle. The FCA notes that £760m was paid by the FSCS in redress for PIFs that left the market between 2016 and 2022; with 95% caused by just 75 firms. The proposals are no doubt motivated in part by the recent BSPS saga, which has resulted in significant liabilities falling on FSCS, and which also saw asset retention rules imposed on firms which had given DB transfer advice to BSPS members.

The proposed rules apply to PIFs – that is, non-MiFID investment firms. The FCA predicts that its new rules will result in approximately 750-1550 PIFs (out of the circa 5,000 in the UK) having to set aside extra capital, and 40-150 PIFs being required to retain assets.

The new proposals will require PIFs to quantify an overall amount, and set aside capital resources, for all of the firm's *"potential redress liabilities"*. "Potential redress liabilities" fall into two types: (i) unresolved redress liabilities and (ii) prospective redress liabilities. 'Unresolved redress liabilities' are actual claims or complaints that have been made to the firm, or which have been referred to the FOS or the courts. 'Prospective redress liabilities' are instances where a firm has *"identified recurring or systemic problems or foreseeable harm which may lead to an obligation to provide redress".*



The FCA has also set out a three-step process which PIFs will need to follow in order to quantify potential redress liabilities. Firms should;

1) estimate the redress amount in each case;

2) aggregate (i.e. add up) the redress amount for each customer; and

3) apply a probability factor in order to calculate the potential redress liability.

For step 1 of that process (estimating the redress amount), firms will be required to make a reasonable estimate of the funds needed to pay redress to each customer if the liability crystallised. Critically, PIFs will be able to account for their PII cover when estimating this amount, and the FCA says that firms will need to ensure they properly understand the precise terms of their cover, as they will need to consider exclusions, the limit of indemnity, and excesses. How, though, will this operate in practice, and how might the FCA's proposals impact upon firms' PII arrangements?

In large part, 'unresolved redress liabilities' ought to have been notified to PII providers, and PII providers will usually have confirmed whether cover is available and on what terms (such as, for example, the excess that will apply if a claim is upheld). PIFs will often, though not always, have a good grasp of how much redress will be payable if the complaint is upheld.

The second type of potential liability, 'prospective redress liabilities', are likely to cause more difficulty. The FCA says that these are instances where a firm has *"identified recurring or systemic problems or foreseeable harm which may lead to an obligation to provide redress".* This is a very nebulous test. How does it fit with firms' root cause analysis obligations and the requirement to contact customers who may not have complained (under DISP 1.3)? What is meant by 'foreseeable harm' in this context? How does it align with the Directors' obligations to assess and quantify contingent creditor liabilities when considering the firm's solvency? 'May' is also a very low bar – generally, when used in an insurance policy, it means a 'more than fanciful' possibility.

The majority of PII policies currently available in the market have a relatively high notification threshold, and will only accept notification of matters 'likely' to give rise to claims. Other policies have even more stringent notification requirements, allowing only for notification of identified claims by named claimants, and expressly barring the notification of issues such as market-wide reviews. Many policies have exclusions for thematic events, or will introduce those exclusions once it becomes clear a particular issue is systemic (such as an exclusion for BSPS advice). This could leave PIFs in the rather invidious position where they are required to make provision for matters which 'may' or 'might' lead to an obligation to pay redress, in circumstances where those matters may not meet the threshold for notification under the terms of their PII policy. It will also be very difficult for firms to assess how much PII cover will be available, as the question of how many excesses will apply to a claim, or whether an exclusion will apply, is often very fact-specific and requires expert input, or cannot be assessed properly until claims have actually materialised. Firms could also potentially find themselves with gaps in cover, or find it difficult to change insurers, if they have identified prospective redress liabilities which cannot be validly notified.

Complying with the proposals is also likely to be costly. The FCA says that identifying a prospective redress liability is not an admission of wrongdoing – but what the FCA seems to be proposing is that firms must carry out a 'back book' review every time they identify some sort of 'foreseeable harm' which 'might' lead to an obligation to pay redress. The proposals will require PIFs to set aside capital until a potential redress liability has been 'resolved'. For the first type of potential liability, 'unresolved redress liabilities', that means waiting until the FOS referral period has expired before the capital can be released, or until the complaint has worked its way through the Ombudsman system (CP 23/24 is silent as to whether PIFs will have to wait until court claims are resolved if claimants have litigated via the courts rather than using the FOS – but we assume this will be dealt with in the final rules). For 'prospective redress liabilities', the capital must be set aside until firms have investigated the issue and either paid redress, or determined that no redress is due. It's not clear at this stage how detailed or granular the FCA expects those investigations to be, but this could imply a full back-book review of each individual case – a hugely onerous obligation, and potentially a very large expense for firms.

Conclusion

The unintended – or, perhaps and more worryingly, entirely intended – consequences of this proposed new prudential regime for PIFs are many and varied. It will likely have a huge impact on the wealth management M&A market, for example. With MIFIDPRU bedding in, it seems far more sensible to create a MIFIDPRU-lite regime for PIFs, limited to the capital adequacy required to reflect identified risks rather than go (arguably) further for non-MiFID firms – and wreak havoc…

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Platforms as Gatekeepers and Guides

In recent years, the FCA has increased its focus on investment platforms and the role they play in wealth management. In September, the FCA published a 'Dear CEO' letter with its platforms portfolio supervisory strategy, highlighting areas of concern where platforms were failing to prevent consumer harm.

Introduction

It went further in its expectations of platforms than ever before, on the basis that the platforms' position within the distribution chain gives them greater visibility and therefore responsibility to act as "gatekeepers" and prevent consumer harm. These expectations are set out alongside Consumer Duty considerations to impose greater responsibility (and potential liability) to protect consumers.

With the FCA scrutinising – and firms' own fair value assessments calling into question – their charging structures, particularly retention of interest on client money, platforms are being asked to do ever more for less. And yet, the Treasury and FCA want these firms to lead the charge to fill the advice gap by offering 'targeted support' or 'simplified advice' under proposals being considered as part of the Advice Guidance Boundary Review (AGBR).

However laudable the aims, there is an inconsistency (or at least an inherent tension) between inviting the platform market to devise new 'guided' distribution models and take regulatory risk by 'supporting' clients with their investment decisions while at the same time insisting they take more responsibility and offer better value.

Gatekeepers

Non-Standard Assets (NSAs)

Among the harms listed is platform firms' historic failure to conduct proper due diligence on NSAs, which has led to customers holding unsuitable high-risk investments. The FCA expressed concern that platforms are not properly acknowledging or accurately calculating their liabilities relating to NSAs, which could lead to delays in customer redress payments and increase the potential for firm failure.

The FCA stated that many NSAs have turned out to be scams, causing consumers to lose significant amounts of money. In respect of those where platforms did not carry out adequate due diligence, the FCA expressed the clear – if surprising – view that platform firms could be liable for losses suffered. Platform firms were warned that they should not assume that they have no liability on the basis that other firms were involved in the distribution chain.

Consequently, the FCA expects that all firms should know whether they took on NSAs and have accurate records, including up-to-date valuations. Boards of platform firms must also seek assurance on the level of due diligence carried out when their firms took on NSAs. Should the level of due diligence be found to have been inadequate, firms should assess whether this has led to consumer harm and the extent of their potential liability, ensuring that they have adequate financial resources to cover this. Additionally, the FCA expects firms to consider carrying out a remediation programme with consumers who have suffered a loss that may have been caused by due diligence failings.

Notwithstanding all of the above, the FCA has not previously issued any guidance (of which we're aware), and its Handbook imposes no specific rules on what platform firms are required to do in respect of NSAs (save for capital adequacy requirements in respect of SIPP accounts). It seems the FCA considers it uncontroversial that, like SIPP providers and the due diligence liabilities imposed on them by FOS after the *Berkeley Burke* saga, platforms face liabilities for having 'allowed' consumer harms, despite having acted within the FCA's rules and available guidance.

Consumer Duty

The FCA also highlighted failures to meet platform firms' Consumer Duty obligations. This includes the 'price and value' outcome that requires the price paid for a product or service to be reasonable compared to the overall benefits. Platform firms may not be meeting this standard through their fees not offering fair value when taking into account the platform's role in the distribution chain or due to customers having varying amounts of funds invested.

In addition, the FCA identified additional emerging risks where consumers may not be receiving fair value where interest payments are accrued on customers' cash balances without appropriate disclosure. We consider this issue in greater detail in our Consumer Duty article.

Concurrently, deficiencies were identified relating to the 'client understanding' outcome in that that platform fees are not properly disclosed to consumers, making it difficult for them to have a clear understanding of what they are being charged and make judgements as to the value of the service they are receiving.

A further emerging risk of consumer harm is the encouragement of risky short term trading by trading apps using 'gamification', resulting in such apps failing to deliver best value for customers. The FCA expressed the need for platforms to maintain controls to understand and monitor customers' trading activities and ensure customers are adequately informed of risks and are protected from reckless trading and scams. This gives rise to another inconsistency or tension; between the risks arising from 'gamification' or digital distribution models that can facilitate high risk investing, and the policy intension of using technology and 'nudges' to facilitate low cost, innovative solutions for mass market retail investments.

More generally, the FCA reiterated the need for platforms to assess fair value and total costs across the whole distribution chain to ensure the fee that they charge is proportionate to the service they are providing and fits with the wider service provided to the customers. Platform firms' position at the end of the distribution chain created a significant responsibility to act as gatekeeper. The FCA's letter warrants quoting in this regard: "Your business performs a key function within the retail investment value chain as a gatekeeper to multiple funds and shares for advisers and consumers".

The FCA also stated that the platform firms faced the particular risk that the quality and value of product offerings or the quality of communications with customers do not deliver good outcomes for customers. This could be a result of products carrying excessive costs and charges, charges not being clear enough for customers to evaluate comparisons, not designed with the target audience in mind, or not suitably marketed to the right target market.

The FCA reiterated that under the Consumer Duty, firms' communications are required to provide the information customers need, at the right time and presented in a way that the customer can understand. Consequently, platform firms need to evolve operationally on an ongoing basis to meet their customers' needs, as careful consideration of product offerings and the risks involved, and how these are communicated to consumers, is needed.

The FCA therefore set out that it expects firms to ensure fair value assessments work in practice and subsequent assessments are thorough and effective. Additionally, where firms determine that they have a material influence on customer outcomes, they must consider their responsibilities under the Consumer Duty and ensure they are appropriately prepared, and have made any changes needed to governance and controls. This is required alongside positive changes to fees and charges, including clear disclosures and communications as described above to ensure fair value, and promote and support consumer understanding.

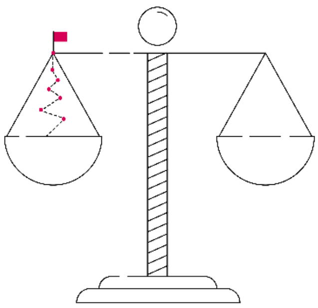
Operational resilience and controls

The FCA's letter also focused on platform firms' actions to enhance operational resilience, stating that these would also help firms meet the requirements of the Consumer Duty. The FCA warned that platforms that underinvest in operational infrastructure run the risk of service disruption or firm failure, potentially resulting in consequential losses to investors and market detriment. Additionally, this would also hamper innovation, increase costs and possibly result in vulnerabilities which can be exploited to access customer information or systems. These vulnerabilities may be exacerbated where operational investments do not keep pace with business growth, or technology migrations are poorly planned and executed.

Consequently, the FCA sets out that platform firms' resources, including people, processes, technology, systems and controls, should be commensurate to the scale and nature of their business operations. Alongside this, firms must have contingency plans in place to deal with operational disruptions and ensure that the plans are routinely tested. The FCA also noted that where firms rely on third parties to deliver services (whether intra-group or external), they should ensure there is adequate oversight, skills, and knowledge to make sure that third parties will continually deliver a service which allows platforms to meet their regulatory obligations.

Furthermore, the FCA stated that platform firms' position within the distribution chain gave them special responsibility to act as gatekeeper in identifying and protecting consumers from fraudulent actions. These could include rogue advisers misusing the adviser charging function to overcharge customers or persons acting on behalf of vulnerable customers not acting in their best interest.

Therefore, the FCA stated that in addition to its expectations above, platform firms must rigorously monitor the use of adviser charging functionalities and where any misuse is identified, must intervene to protect consumers' interest. Additionally, firms must have appropriate systems and controls in place to mitigate any monetary loss or potential harm caused by fraudsters. Such fraud controls should be reviewed on an ongoing basis and updated where necessary and be considered as part of a firm's Consumer Duty obligations.



Guides

Advice Guidance Boundary Review

A little over two months after the platform portfolio strategy letter, in December, the FCA and Treasury published the long-awaited discussion paper on their combined AGBR proposals (DP23/5), saying "Everyone should have access to financial advice". Sarah Pritchard of the FCA said in the foreword: "To succeed in closing the advice gap, industry needs to play its part. We expect firms to actively engage with this review and consider how they can better support their customers. This means being bolder and embracing the opportunities that data and technology bring to offer more accessible, affordable and innovative services to consumers".

The paper noted that 8% of adults (some 4.4m consumers) reported taking advice in 2022. 60% of those who had not taken advice had at least £10,000 of investable assets but said they did not need advice. Some 12.9m (24% of consumers) had used information or guidance services to help them with decisions about investments but research suggests that the guidance currently available (through, for example, MaPS, private sector websites and workplaces) doesn’t go far enough to help consumers feel confident about investing.

More worryingly, 5.7m UK adults (11%) held high-risk investments in 2022, including CFDs and cryptoassets, with younger adults more likely to be in this group. Remarkably, 23% had no or a very low tolerance for risk! In a sign of the times, social media was used by 18% of investors to research investments, find opportunities and stay updated. This increased to 54% of new, younger investors. The paper laments that only 1.5% of adults used a robo-adviser in 2022; noting research that suggests this is because consumers prefer an element of human interaction. The (so-called) Online Discretionary Investment Managers – i.e., mostly the tech start-ups – may try to guide clients into self-selected model portfolios or carry on with their simplified advice journeys. Either way, it seems the future is likely to involve hybrid models with technology alongside human interactions.

Despite the obvious need, the proposals are relatively low on ambition, with re-heated plans to clarify the advice guidance boundary and plans to revisit simplified advice models (despite the damp squib that was the 'core advice' regime proposal from the year before). The novel idea is 'targeted support', akin to the 'personalised guidance' proposed by the likes of Hargreaves Lansdown, but with suggestions based on what 'people like you' might do, rather than data-driven individualised investment suggestions. Taken together, the proposals could (apparently) "smooth the cliff edge between holistic advice and information and guidance and create a continuum of support that would help many more consumers to make informed investment and pension decisions".

The problem, as ever, is that legal certainty and regulatory compliance don't work well with 'continuums'. Firms need clarity and precision about the dividing lines between different services and propositions. In terms of the further clarity on offer, the FCA says firms have an "overly cautious interpretation of the current regulatory framework". How often does the regulator invite firms to take more regulatory risk?

Further clarity

The FCA is proposing to create more non-Handbook and Perimeter guidance with further scenarios - as if PERG 8 Annex 1 isn't already painful enough to navigate - or to simplify existing guidance to give greater certainty. It is recognised that this alone cannot fill the advice gap but is "designed to encourage firms to do more under the existing framework". It is difficult enough to design and build a compliant proposition that 'treads' the advice guidance boundary but harder still to operate and monitor it in the real world when real people (staff and clients) are involved. And that's before FOS is likely to undermine all the good work with arbitrary decisions that have profound impacts through firms' root cause analysis obligations. See, for example, the very badly timed publicity about a FOS complaint upheld against a large national wealth manager where the client believed they were advised when the firm was adamant they were not. As regulatory lawyers, we might get comfortable that an occasional adverse FOS decision, based on the selective memories of a client, doesn't have to break an entire business model, but it is a brave firm that persists with its proposition knowing that it could be found liable at any time.

The discussion paper's comments on FOS and the DISP rules are very odd: "We are not proposing to remove the requirements of firms to comply with the FCA's Dispute Resolution Sourcebook, However we would be interested to hear whether the solutions identified … would provide firms with the clarity they need on the FCA's expectations of them in ensuring good outcomes for consumers when providing a broader level of support, so they can seek to avoid causing consumer harm that incurs redress liabilities". Rather than bring FOS to heel, the FCA wants to know if firms can get sufficient legal certainty to avoid incurring liabilities via a complaints scheme that can disregard the law! At least question 29 asks if there should be any amendments to DISP to enable firms "to provide different levels of support". The answer must be: "yes, or else this won't work".

More simplified advice

Simplified advice has been tried many times before, even before the ill-fated 'core advice' regime was floated in CP22/24. The FCA notes the failure of FG17/8 to create a 'streamlined advice' regime. That guidance itself followed the retirement of FG12/10 on 'simplified advice', FG15/1 on 'clarifying the boundaries…' and FG12/15 on 'independent and restricted advice'. The FCA sums up the failed interventions, understating the obvious that they "did not give firms legal certainty…".

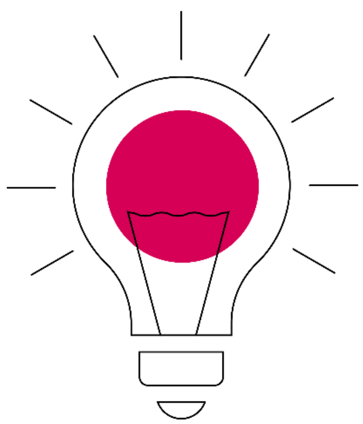
This latest attempt at providing clarity would be for advice firms but also "platforms, retail banks or other product manufacturers". It would involve "one-off advice, focused on one specific need, and does not involve analysis of a consumer's circumstances that are not directly relevant to that need". There is a suggestion of limiting such simplified advice to £85k to mirror the FSCS limit - which is hardly encouraging to an industry worried about systemic liabilities rendering their firms insolvent. The FCA is open to repeated instances of one-off simplified advice but one can see how that gets problematic with limits, prior knowledge and assumed responsibilities.

Maybe this latest version of simplified advice could work, perhaps as part of a package of reforms across the retail investment market - and if and only if backed by FOS – but let's not get carried away….?

Targeted support

The most novel and ambitious proposal is called 'targeted support'. The FCA notes: "Significant technological innovations have improved firms' ability to capture and use customer data in a way that leads to better consumer outcomes". Aligned with PROD and Consumer Duty target market assessments, the idea is that firms could "Use limited personal information about a customer and their circumstances to provide support to consumers to help them make an informed decision. The action suggested to the consumer would be appropriate to a person in similar circumstances (i.e., a target market the consumer can be identified as belonging to) and could result in the firm suggesting options to the consumer on the basis of 'people like you'". This could be without explicit, upfront charges exclusively relating to the service provision but with clear disclosure as to how the client pays through other associated charges.

In a contorted summary, the FCA suggests "Targeted support would be an innovative type of support, sitting between both information or guidance and simplified or holistic advice. It would allow a firm to identify whether a consumer falls within a target market and ensure that the suggestion made to the consumer aligns with the needs, characteristics and objectives of that target market, while acknowledging that the consumer may have individual needs that have not been identified". Identifying the target market and the correct size and characteristics will be hard enough but knowing enough about the client to fit them within the right target market whilst disclaiming responsibility for unidentified individual needs will pose the greatest challenge. In respect of Consumer Duty obligations, the FCA acknowledges that firms would need to "determine the extent of the information to be collected from their client to deliver targeted support", that the service is likely to provide a better outcome than would reasonably be expected without it and that the client can understand the outcome that the suggestion is intended, but not guaranteed, to achieve.



The FCA acknowledges that this regime would best suit providers and larger, typically non-advisory firms "including retail banks, life insurers and platforms – who can use customer data and product knowledge to provide great support…" It could be limited to vertically integrated firms providing support on their own product suite. These are the firms likely to have sufficient volumes of and systems for client data. They will be the ones most likely to employ digital process and potential scripted support by customer service personnel. To encourage targeted support services, the FCA may relax its rules on cross-subsidies in the adviser charging rules but without bringing back commission models. This too would favour larger, more established, vertically integrated firms. This seems to run contrary to the direction of travel for pricing and fair value assessments described above and in the article on Consumer Duty and interest retention.

Disclosures would be key to enabling consumers to decide if the service meets their needs or whether they might need more bespoke support. However, this looks much like the firms' obligations to ensure consumer understanding under the Consumer Duty. Firms would need to make clear the limited nature and types of data to be collected, albeit the firms would be making significant use of their client data generally to identify target markets and into which one the client falls. The 'support' or 'suggestion' would not be a recommendation (and certainly not personalised to the individual) but based on a target market of 'people like you'.

The FCA recognises the need for firms to have a framework which gives the clarity and the certainty to operationalise and deliver the regime, and "for the regulatory family [to have] a framework which gives the FCA, the ombudsman service and FSCS clear and unambiguous responsibilities to ensure that market participants conduct themselves in a fair, reasonable and compliant way and consumers are protected from market participants who do not". Again, this strange form of words suggests no intention of bringing FOS to heel.

The reform could be introduced via a new regulated activity, a sub-permission under Article 53 ('advising on investments') or by allowing authorised firms to provide targeted support where they have certain existing permissions linked to relevant products.

The FCA's graphic (page 17) neatly summarises the advice gap and current difference between information or guidance and holistic advice. The proposals for filling the gap may help but don't bring the two extremes close enough together to create the kind of continuum of service levels that might ultimately succeed. We always summarise the different service levels as follows: "this is a gold fund" – information; "this is a good gold fund" – guidance or general advice; and, "this is a good gold fund for you" – personal recommendation advice. The dream of many is to enable 'personalised guidance' which may prove an impossible oxymoron. The current proposals merely add to the options: "this is a good fold fund for you to invest in if you want a gold fund" – simplified advice; and, "this is a good gold fund for people like you" – targeted support.

Conclusion

Overall, whereas previous reviews of platform firms' services, such as in the Platforms Market Study of 2019 (MS17/1), focused on increasing market efficiencies such as through reducing transfer barriers, the FCA appears now to be increasing regulatory pressure on platforms significantly. Whilst reiterating its expectations for platform firms to ensure costs are reasonable and consumers are able to transfer easily, the FCA is also creating responsibilities for platforms to act as gatekeepers for the provision of retail investment services more generally. Combined with the enhanced obligations on platform firms arising out of the Consumer Duty, and the FCA's continued expectations of robust and up to date operational structures, the regulatory burden (and associated costs) borne by platform firms is greatly increased. In respect of NSAs, these challenges are compounded by the FCA stating that firms may face liabilities in situations where platforms were not sufficiently thorough in their due diligence.

Nevertheless, the FCA rules and guidance have not to date placed any specific restrictions or obligations concerning NSAs on platform firms. Additionally, its previous and current expectations on platform firms to provide good value and flexibility to consumers is generally concerned with preventing consumers from incurring additional costs. This can be said to be inconsistent with the imposition of the extensive gatekeeper responsibilities placed upon platform firms as described above, not to mention the potential NSA liabilities and resulting financial resources requirement. Indeed, many platforms that operate on a 'low cost' business model, providing a basic but cheap and efficient service to consumers, may find it difficult to meet the described gatekeeper responsibilities without increasing their fees, potentially resulting in a reduction in market competition and decreased value to consumers.

Against that backdrop, the FCA wants firms like these to engage in potentially significant regulatory reform and embrace novel, uncertain and risky new business models. Firms have until 28 February to respond to the AGBR to point out that the FCA can't have it both ways.

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Enforcement – the law still matters

Over recent years, the FCA has suffered a number of failings in the higher Courts with some of its Enforcement decisions being heavily criticised and overturned. These failings act as an all-too-important reminder that the FCA's powers do not operate in a vacuum but instead arise out of a set of legal principles, which must be upheld to ensure that Enforcement decisions are firmly rooted in both facts and law.

FCA's recent failings in Court

In *BlueCrest Capital Management v FCA*, the Upper Tribunal found that the FCA had exceeded its powers in imposing a single redress scheme based solely on an alleged breach of its Principles for Business. In particular, the FCA failed to establish a causal link between the alleged breach of duty and the loss suffered by consumers. This decision is important as it stresses the need for legal liability to exist before the FCA can impose a redress scheme on a firm. The FCA is not giving up – its appeal is due to be heard in July.

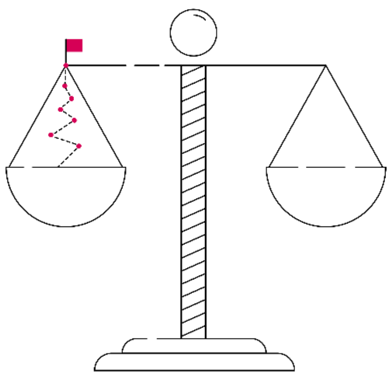
In *Markos Markou v FCA*, the Tribunal openly criticised the FCA's decision to impose a financial penalty and prohibition order on the basis that the applicant had lacked integrity in his oversight of a mortgage business. The Tribunal criticised the FCA's approach and invited the regulator to reconsider its decision, having found no evidence of a lack of integrity on the part of Markou upon a factual review of the FCA's case. We anticipate that this case will have implications for the future of SM&CR Enforcement action; the FCA will need to have hard evidence to support any findings regarding integrity.

In its Court case against Paul Steel, the FCA alleged that he gave consumers unsuitable defined benefit pension transfer advice and sought a restitution order against Mr Steel personally for up to £7 million, thereby 'piercing the corporate veil'. The case was settled in July for a fraction of the claim[2], no doubt with the Court of Appeal's words from the *Ferreira* case (albeit about financial promotions breaches) ringing in the FCA's ears: "the intention to introduce such a radical departure from the principles of limited liability in the financial services field should not be attributed to the legislature in the absence of some very clear indication – of which there is none."

Let's hope this is the last of the FCA's attempts to seek restitution orders against individuals, for mere negligence or compliance failures.

In *Seiler, Whitestone and Raitzin v FCA*, the Upper Tribunal found that the FCA had failed to establish that three former employees of Julius Baer had acted recklessly or without integrity in response to allegations that they had negotiated and facilitated "finder's arrangements". Critically, the Tribunal rejected the FCA's submission that subjective awareness of the risk was not a prerequisite of a finding of recklessness and argued that recklessness could be established if a reasonable person in the applicant's position would have been aware of the risk in question, regardless of whether that applicant had actual knowledge. The Tribunal also criticised the FCA for the lengthy delays and improper handling of the investigation process and found that there had been "serious failures" by the FCA when dealing with disclosure.

Finally, in the hotly contested and unpleasant case of *Frensham v FCA*, the Upper Tribunal held that criminal offences in isolation are not sufficient to establish that an individual is unfit to hold a regulated position in financial services. Instead, the onus is on the FCA to demonstrate the necessary link between the offender's conduct in their personal capacity and the consequences such conduct has on their regulated practice in light of consumer protection objectives. As so often, 'the cover up was worse than the crime' and Frensham was banned[3], but because of misleading the regulator rather than the original offending behaviour.



[2] FCA bans Paul Steel for unsuitable defined benefit transfer advice with £850k to be paid in redress | FCA

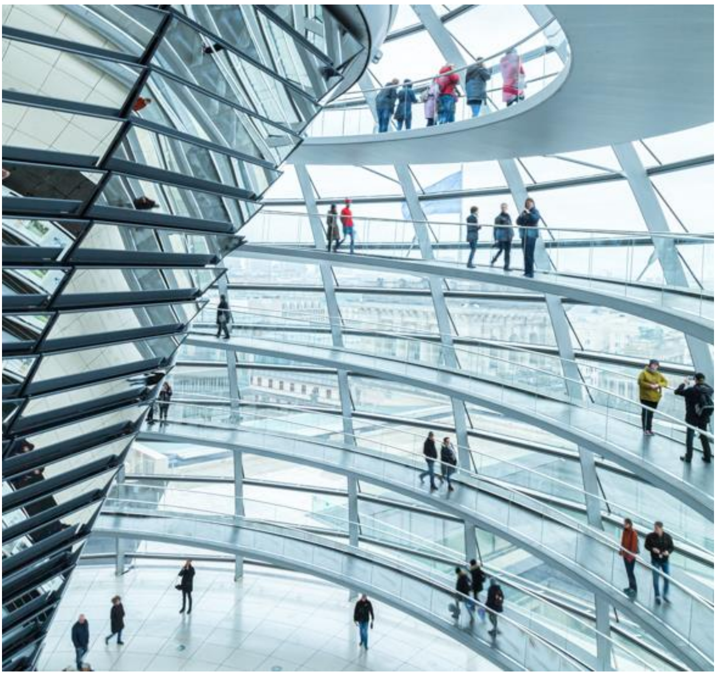
[3] FCA bans Jon Frensham from working in financial services | FCA

What next?

Given the advent of the Consumer Duty, increasing concerns about arbitrary regulation based on uncertain, subjective judgements made in hindsight are understandable. These cases act as timely reminders that the FCA still operates within the bounds of the law and that it does not have unfettered discretion to impose any requirements or decisions it wants on the firms and individuals it regulates.

It remains to be seen whether the FCA will take the Tribunal's criticisms on board and adopt new approaches to its Enforcement processes. The FCA has repeatedly said it will take 'legal risk' and, in that regard, it is being true to its word – and losing.

For now, we anticipate that these criticisms will at least find their way into an increasing number of defence submissions in response to current and future investigations.



NFMC

The Upper Tribunal cases also demonstrate the FCA's continued focus on individuals' "integrity" and non-financial misconduct more broadly. Over the course of the last year there has been much publicity regarding the FCA's investigations into both Odey Asset Management and Crispin Odey himself regarding allegations of sexual misconduct. Whilst the investigation into the firm has been closed, Nikhil Rathi confirmed in December that the investigations into "the individual … remain live". Outside of wealth management, we also saw the high profile fine and ban imposed on James Staley[4]; again, less for being associated with Epstein but instead for misleading information.

Whilst non-financial misconduct has been high on the list of the FCA's priorities for a number of years now, this serves as a reminder that it is an ever-present priority of both Enforcement and Supervision, even more so with increased focus on ESG and 'sexism in the City'. In a letter to the Treasury Select Committee in July last year, Rathi emphasised that:

> "non-financial misconduct can amount to a breach of our conduct rules."

and

> "should allegations or evidence of non-financial misconduct come to light we expect a regulated firm to take them seriously through appropriate internal procedures. We can investigate and act against authorised firms that fail in this regard for inadequate systems and controls."[5]

Wealth management firms should, therefore, ensure that they have the requisite policies and procedures in place to deal with any such allegations should they arise.

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[4] FCA decides to fine and ban James Staley | FCA

[5] committees.parliament.uk/publications/40749/documents/198516/default/

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- ESG and Sustainable Business Consultancy: ethical leadership and conduct, organisational integrity, ESG factors, transformational culture change and behaviours, and Diversity, Inclusion and Belonging
- Distribution Models: new propositions and distribution arrangements, client and intermediary agreements, adviser / DFM partnering (e.g. JVs, vertical integration, trading styles, 'agent as client' and 'reliance on others' or outsourcing and co-manufacturing), inducement rules, conflict of interests and adviser charging
- Consumer Duty and Conduct Risk: former FCA skilled persons advise on Consumer Duty implementation and embedding, conduct risk frameworks, compliance and mitigation for firms and their approved or certified persons and senior managers, including the Principles for Businesses, Threshold Conditions, clients' best interests, TCF and vulnerable clients, suitability, conflicts and whistleblowing
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