ADDLESHAW GODDARD

BE AWARE AND BEWARE

The FCA's Dear CEO letters and its Asset Management / Alternatives Supervision Strategy

On 20 January 2020, the Financial Conduct Authority (**FCA**) sent *Dear CEO* letters to both asset management firms[1] (those who manage or advise on mainstream investments), and alternative investment firms[2] (those who manage hedge funds or private equity funds) (the **letters**). The letters cover a broad range of themes: liquidity management, firm governance, product governance, LIBOR transition, operational resilience, client money and custody asset controls, market abuse, market integrity and disruption, anti-money laundering, anti-bribery and corruption and the impact of Brexit.

These are the latest in a series of *Dear CEO* letters that the FCA has published over the past six months. These might seem like routine supervisory communications with no aim beyond providing senior management with easy access to up-to-date FCA thinking on a range of issues that they regard as being the key causes of harm and the corresponding supervisory priorities. But this would be to underestimate their likely impact.

Rather than focusing on the particular themes raised by the FCA, this briefing takes a closer look at the FCA's use of *Dear CEO* letters and the traps they may present for the unwary. The briefing commences with a high-level overview of the key causes of harm set out in the letters before moving on to the FCA's use of thematic work, the dangers of attestations and the expectations that *Dear CEO* letters set. It concludes by considering 'event horizons'.

KEY CAUSES OF HARM

The letters reveal the FCA's pointed estimation of the state of the asset management and alternatives industry. Regulators typically communicate in under-stated tones, not so on this occasion:

> *[w]e believe that progress is needed for the sector to [act in the best interests of its customers]. Overall, standards of governance, particularly at the level of the regulated entity, generally fall below our expectations.*[3]

With respect to alternatives, the FCA highlighted the risk of alternative investments being made available to less-sophisticated investors, a lack of robust CASS oversight and controls in some instances and the threat to market integrity created by weak systems in relation to market abuse and financial crime.

For mainstream asset managers, the FCA noted that funds offered to retail investors do not consistently deliver good value, frequently due to a failure to identify and manage conflicts of interest. An underinvestment in technology and operational resilience was also noted as a risk to market integrity.

The FCA has had the industry in its sights for some years now and has already introduced wide ranging remedies aimed at strengthening protections for investors, placing competitive pressure on asset managers and improving the effectiveness of intermediaries.[4] More recently, the industry has had to adapt to new rules designed to strengthen fund governance.[5] It may be that the industry's recent troubles have caused the FCA to take a close look at the effectiveness of its past interventions in the sector and adopt a bolder approach.[6]

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[1] FCA, Dear Chief Executive, Our Asset Management Supervision Strategy, 20 January 2020, available here.
[2] FCA, Dear Chief Executive, Our Alternatives Supervision Strategy, 20 January 2020, available here.
[3] Para. 3, the letters.
[4] See the FCA's Asset Management Market Study Final Report MS15/2.3, published in June 2017, available here.
[5] See the FCA's Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/18 Policy Statement PS18/08, published in April 2018, available here.
[6] The issues involving Neil Woodford's investment vehicles have caused the FCA to consider rule changes but also brought into focus the quality of its supervision and understanding of the industry.

THEMATIC WORK

A key point, easily lost in the detail of the letters, is the statement that the FCA intends to conduct thematic work. As the letters say: *"[y]our firm may be asked to take part in one or more pieces of work related to these priorities. We expect you to consider them priorities and take appropriate action."*[7]

The vast majority of firms will not be asked to take part in thematic work, but those that do are exposed to particular risk. There will generally be a reason why the FCA has selected the firm to be a part of the study cohort. The ostensible aim of thematic (horizontal) studies is for the FCA to gather information about industry activities. The regulator will be looking for evidence of good practice and bad practice, and will likely publish a report in due course which summarises these findings. In practice, thematic reports often become a type of 'soft law' – a way for the FCA to extend the remit of its concerns and expand the range of its impact.

In a recent speech, FCA CEO-designate Christopher Woolard (speaking in his capacity as FCA's Executive Director of Strategy and Competition) spoke of the 'unwritten rules' with which firms are expected to comply, a reference which may have puzzled many who at the very least expect regulatory rules to be published somewhere and accessible to those expected to comply with them.[8] It would be reasonable to suppose that Mr Woolard meant, amongst other things, published thematic work. Compliance officers will initially be concerned where their firm commits what the FCA has identified as 'bad practice'. Over time, good compliance officers in good firms will seek to implement the FCA's examples of good practice. In this way, 'FCA expectations' move forward even though there is no actual change in rules. That said, a breach of 'FCA expectations' cannot, without more, give rise to a liability to pay compensation or a disciplinary finding against a firm.

Firms that the FCA identifies in the thematic study as falling below its expectations may not simply escape with an admonishment and a call to improve. Those in the proverbial fourth quartile – never a good place to be – may be required to appoint a skilled person. Those who the FCA regards as dipping very far below an acceptable standard may find themselves subject to an enforcement investigation. And of course, in the current environment and post-SM&CR implementation, there may well be an investigation into the conduct of individuals. This is particularly so given that in its planned work to evaluate the effectiveness of governance across the sector the FCA will be focusing on firms' efforts to implement the SM&CR.[9]

Unfortunately, some firms do not understand the nature of an FCA thematic investigation and enter it unprepared. All too often, staff – including senior staff – do little preparation for their interviews, documents are not reviewed before they are given to the FCA, and the FCA's direct questions are answered with too little care. Sometimes the narrative presented to the FCA about the firm is poorly judged – perhaps failing to address problems the FCA is fully aware of. Conversely, that narrative may present too bleak a picture, maybe because it has been put together by a single disenchanted compliance officer. Some firms may inadvertently disclose privileged material in the course of the document request that invariably precedes a site visit. If this were an enforcement or a skilled persons review, or even a period of heated and difficult correspondence with the FCA, the firm would be more alert to and prepared for these dangers. But the thematic investigation holds much less apparent threat. Firms often seriously misjudge the seriousness of the implications.

ATTESTATIONS

Once the FCA has identified harmful practices through its thematic studies, it may require firms to investigate their internal control environments and attest that they are operating to what the FCA deems to be an acceptable standard. The attestation is a particularly insidious supervisory tool in that it shifts the focus from firm to individual accountability by requiring a personal certification by a senior individual at the firm.

When attestations were first introduced in 2016, the apparent ability to self-certify may have led some in the industry to view the FCA as overly trusting. Some attestations were signed without proper enquiry and some firms escaped scrutiny because the FCA will always lack the resources to interrogate every firm that attests to its own compliance. But over time, providing an attestation has become a serious and solemn event, and senior management – in particular those expected to sign the attestation – will often require external legal and/or consultant opinions about the firm's practices and the work that needs to be undertaken before they sign. Addleshaw Goddard has been involved in advising firms on qualified attestations, and has supported firms who have had to tell the FCA that they cannot attest because they cannot give the FCA the assurances it seeks.

Telling the truth is the right thing to do, even though the failure to sign an unqualified attestation will attract attention.

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[7] Para. 4, the letters.

[8] Speech by Christopher Woolard, Executive Director of Strategy and Competition at the FCA, delivered at the City of London / Cicero event on Future of Regulation on 21 October 2019, the text of the speech is available here.

[9] See Addleshaw Goddard's Financial Regulation Briefing, SM&CR Implementation: Third mover advantage – Top tips from implementation projects, 3 September 2019, available here.

In the future, asset management and alternative investment firms will increasingly likely be asked to sign attestations. These could, in practice, be used to force firms to state their view on the quality of their liquidity risk management, product governance and/or operational resilience systems and controls.

SETTING EXPECTATIONS

The FCA's *Dear CEO* letters also set down a marker – they fire a warning shot across the bows of the industry about the FCA's areas of focus. Many of the FCA's concerns about poor practice will not manifest themselves as FCA Handbook breaches. This is not necessarily because the rules have been badly drafted (although some have levelled this accusation at the regulator in the past). It is mainly because the FCA's ability to draft and update its rules can be outstripped by firms' innovations, including innovations in ways of causing customers harm.

In the absence of specific rule breaches, the FCA can and does discipline firms on the basis of breaches of the Principles for Business alone.[10] But by their nature, the Principles are open textured and broad, meaning that some firms genuinely need to be put on notice that their misconduct might give rise to a Principles breach. *Dear CEO* letters amount to a 'putting on notice'. Future enforcement cases are likely to be grounded in breaches of Principles 1 (integrity), 2 (skill and care), 3 (organisation and control), 6 (treating customers fairly), 7 (customers' information needs), 8 (conflicts) and 11 (openness with the FCA). As was said in one famous case, it is the Principles that occupy the field not the rules, and the lack of apparently applicable rules may not be a serious bar to the FCA. This may be most relevant in the area of fund illiquidity concerns, where the rules appear to be distinctly deficient, and fair pricing issues, where again rules have not kept pace with current FCA concerns.

Since its inception in 2013, the FCA has described its approach as 'outcomes-based' regulation, which focuses on the outcomes for the customer, rather than the term 'principles-based' regulation favoured by its predecessor, which focuses on the conduct of the firm. These terms are important as they serve as the driver of supervisory and possibly also disciplinary activity. This has caused concern in some quarters. Whilst alternative investment firms tend to charge an annual management fee plus a performance fee, most asset managers levy an annual management fee that bears no relation to performance of the portfolio. This means that many asset managers – and particularly those with retail clients – are charging the same annual management fee in a bear market as a bull market even though the value of the customers' investments will likely have fallen. The justification for this is easy to see; the amount and quality of work required to manage the portfolio remains the same irrespective of market direction. But is there a risk of the FCA arguing that this is not a fair outcome for the customer even where the fund complies with the FCA's value for money rules? Some of these themes will be explored in a future briefing.

THE EVENT HORIZON

Enforcement has become a well understood legal process. Nearly all firms in enforcement retain lawyers for advice and representation.

Less well understood is how firms find themselves in enforcement, how they pass the event horizon so that the gravitational pull towards a disciplinary investigation becomes near impossible to resist. There are many routes, but a clear cause is many firms' failure to recognise the danger they are in and take advice. In conclusion, the letters may well lead to very bad outcomes for those who do not look out for themselves.

The best practical course is to view these letters as indicating a clear direction of travel. Firms will always be better off identifying issues themselves, remediating systems and controls where needed and making any disclosures to the regulator as are appropriate given the gravity of what's been identified. Where the FCA identifies the mishap, the outcome will invariably be significantly worse.

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[10] The Principles can be viewed [here].

If you have any questions, please do not hesitate to contact your usual AG contact or one of the lawyers listed below:

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