



# Improving the Appointed Representatives Regime

INSIGHTS TO SUPPORT THE FCA'S NEW AR REGIME RULES

8 December 2022



*Thursday 8 December 2022 is an important day for the Appointed Representatives (AR) regime in the UK. The rule changes set out in the FCA's Policy Statement 22/11 come into effect, raising the bar for all firms operating in the sector.*

The AR regime brings a number of benefits for the UK economy – not least by allowing entrepreneurs to get off the ground quickly without the substantial time and cost associated with direct FCA authorisation. More importantly, those enterprises can flourish, safe in the knowledge that institutional-grade compliance infrastructure and expertise is being provided by their regulatory host. However, historically, some principal firms have cut corners. They have taken on ARs without the right controls to understand those businesses and their risks, or the ability to monitor their activities closely. This has resulted in some poor outcomes for end customers.

The move to improve the AR regime dates back to early 2019, when the FCA issued a 'Dear CEO' letter scolding regulatory hosting firms for "significant shortcomings in the control and oversight of ARs." The landscape looks much improved today, although it is only with the publication of these new rules in August 2022 that principal firms have really assessed whether they are properly equipped to manage ARs. From a responsible principal firm's perspective, there are two major positives to the new, stricter rules. First, the benefits of the regime are acknowledged: "increased customer choice; providing principals and ARs with a cost-

effective way to comply with regulation; providing market access for smaller firms and supporting innovation as some firms use the model to trial new services and propositions". Second, the enhanced rules will encourage weaker players to drop out. The bar is higher and those who cannot meet the standards need to leave, which will benefit the remaining principals who are prepared to invest in the people, systems and processes required.

In our view, the regime is suitable for ARs focused on the institutional investment market; less so for mass retail, where end consumers deserve to know that the firms they're engaging with are under direct FCA supervision.

After a four-month run-up to allow firms time to prepare, the new rules have taken effect as of **8 December 2022**. Throughout the preparation period, IQ-EQ's UK Regulatory and Compliance Solutions team has shared a series of insights highlighting the significance of the new rules, outlining the key changes, and pointing ARs in the right direction. Now, to mark the implementation date, we've compiled all of our recent insights into one concise paper that we hope will help guide our clients and contacts forward in this enhanced regulatory environment.

## What are the key changes?

The rules have been tightened in a number of areas. All of the new requirements support the view that the AR regime is not a soft touch; rather, it is designed to provide swift and potentially short-term access to regulated activities while a firm prepares for full authorisation or grows to a sustainable size when it can afford its own compliance infrastructure.

The most important changes are:

- 1. Principals need to collect more data on ARs, meaning they need adequate staff and robust processes.** This includes data on the nature of activities, revenues, complaints, and whether the AR was previously associated with a different principal firm. In particular, an annual review of ARs activities, business and senior management is required
- 2. Principals must notify the FCA 30 days before new AR appointments take effect,** which is likely to delay the process
- 3. Firms wishing to offer regulatory hosting services must identify themselves to the regulator,** which might indicate that there will be further FCA supervision
- 4. Principals need to conduct more monitoring, including an annual assessment of the fitness and propriety of individuals at their ARs.** This means the principals' monitoring teams need to be well resourced and highly skilled. There is an expectation that principals should oversee individuals at ARs to a comparable standard as if they were directly employed by the principal
- 5. The governing body of the principal firm must sign off annually that the firm is complying with all its obligations.** This means that the governing body needs to be closer to the detail on individual AR arrangements
- 6. The circumstances under which principals should terminate an AR relationship have been clarified,** and any wind-downs resulting from a termination decision must be conducted in an orderly manner

# A spotlight on regulatory hosting

All in all, the new rules affect about 3,400 principal firms and more than 37,000 ARs. The regulatory hosting sector is a smaller but very important sub-set of this. The FCA identified in its 2018 thematic review approximately 1,000 ARs across a diverse range of business models, including asset management, promotion and management of alternative investment funds (AIFs), wealth management, fund advisory, corporate finance advisory and even contracts for difference providers.

We estimate that today there are around 60 dedicated regulatory hosting businesses in the UK with between 10 and 80 ARs each.

These firms exist solely to offer hosting services and as such are likely to have invested in the processes, people and systems required to ensure effective oversight.

There are also many authorised firms that have one or two (likely closely connected) ARs – for example, a large multi-strategy hedge fund manager may offer to host a successful investment team that wants to set up its own business.

Under the new rules, firms that intend to offer regulatory hosting as a business line must **notify the FCA at least 60 calendar days before offering services**. Following feedback on its previous consultation paper, the FCA has refined the definition of ‘regulatory host’ to a firm that:

- Offers or provides a service by which unauthorised persons, whether or not in the same group as the firm, may become ARs of the firm
- Provides this service for remuneration with a view to profit

The notification will provide an accurate figure of the number of regulatory hosts but more importantly will allow the FCA to enhance its supervision of the regulatory hosting sector.

Following the Greensill Capital scandal, hosting is regarded as the riskiest part of the principal sector, especially hosts that allow ARs to provide products and services to retail clients and investors. We expect further supervisory activity in 2023 to assess the adequacy of governance and effectiveness of monitoring.

## Supporting the FCA’s economic growth objective

In tandem with the enhanced AR regime rules, a new objective has been proposed for the FCA to support UK economic growth. We believe the improvements to the AR regime for regulatory hosts can help the FCA achieve this new goal.

The Financial Services and Markets Bill – introduced to UK Parliament on 20 July 2022 and likely to become law in early 2023 – will give the FCA a new objective to encourage UK economic growth. At the Future of UK Financial Services Regulation Summit in October, FCA executive director Sarah Pritchard stated: “we are clear that we want to support long-term competitiveness and growth of the UK economy, and know we can do so by being an effective regulator.”

Pritchard’s speech also highlighted that the FCA has helped more than 160 growing businesses to test their offering using its Regulatory Sandbox (launched in 2016), with over 90% becoming authorised. This initiative sits alongside the

FCA’s new and innovative Early and High Growth Oversight approach, which aims to support 300 newly authorised businesses by spring 2023. As such, the UK remains the most attractive destination for FinTech in Europe and second only to the United States globally.

The regulatory hosting sector has many similarities to the FCA Regulatory Sandbox, but focuses its support on asset management rather than FinTech entrepreneurs. Indeed, the sector includes around 340 regulatory hosts supporting over 1,000 ARs that are mainly entrepreneurial start-up financial services businesses, with many focused on the management of alternative investment funds (AIFs) including hedge, private equity, real estate and increasingly ESG funds.

The outcome of the support provided by the sector is the broadly the same: helping the UK remain the most attractive destination for asset management start-ups in Europe and the second-most attractive destination globally.

In recent years, some of the leading principal firms have invested heavily in expert people and technology to enhance governance, risk management, onboarding due diligence and ongoing monitoring in anticipation of new stricter rules coming into force. As a result, the best regulatory hosts now provide institutional-quality risk and compliance infrastructure to start-up businesses. When an entrepreneur chooses the right hosting firm, their start-up businesses are brought to market with stronger oversight by a host than if they had sought direct FCA authorisation at inception.

The strengthening of the regulatory hosting sector directly serves to boost UK-wide economic growth with its support for entrepreneurs starting up and growing regulated financial services businesses across the UK. TheCityUK, the

industry body representing UK-based financial and related professional services, estimates that the financial services industry “contributes over 12% of the UK’s total economic output, is the largest taxpayer and employs over 2.2 million people across the country – two thirds of whom are based outside London.”

What’s more, the regulatory hosts themselves are part of this UK-wide growth. Using IQ-EQ as an example: in addition to our flagship London office, we have rapidly expanding offices in Belfast and Newcastle, creating professional accounting and compliance roles in these cities to support the newly launched funds and growing asset management businesses we serve.

## Five questions every AR should ask their principal

While principal firms must conduct a detailed risk assessment of every incoming AR during onboarding, responsible financial services businesses should also complete due diligence of their own when selecting a host. In light of the new rules and the increased regulatory scrutiny of the sector in general, it is in the interests of every AR to ask the right questions and ensure their principal firm isn’t cutting any corners.

The key questions are:

### 1. How are conflicts of interest managed?

It’s critical to assess how your principal firm manages conflicts of interest. A key conflict arises because ARs are paying for a service, so the firm may be incentivised to reduce its onboarding due diligence and compliance oversight to bring on and retain more business. There is a real risk that the firm’s senior management prioritises commercial goals ahead of adequate and robust supervision

We recommend reviewing the FCA register to assess if the firm’s board and senior manager appointments are sufficiently experienced to provide adequate governance. Also, whether the board is supported by a team that can review policies and procedures to provide regular audits of the adequacy of risk management and systems and controls. It is particularly important to check if the CEO (SMF1) and

the Compliance Officer (SMF16) are the same individual. We believe that the conflict can only be effectively managed by appointing one person as SMF1, responsible for commercial targets, and a separate, suitability experienced and competent person as SMF16, responsible for compliance and able to challenge decisions made by the SMF1 when necessary

### 2. Do you have sufficient expertise to oversee different AR business models?

It has always been important for principal firms to understand the business models of their ARs, and increased oversight makes it doubly so. There are very different levels and types of risk depending on whether the ARs provide services to professional or retail clients. We believe better oversight can be achieved by firms that focus on servicing either ARs with professional clients or those with retail clients, but not both

Further, a firm needs expertise in different asset classes. For example, it can’t appropriately oversee an AR whose business activities involve cryptocurrency without understanding that asset class and its associated complexities. A responsible firm should limit their activity to the business models they thoroughly understand. We recommend checking if the firm has an advisory team with specialist experts in place to support the monitoring team.

### 3. How do you ensure effective monitoring and oversight?

We recommend asking if, during onboarding, a thorough and detailed risk assessment is carried out to determine the level and type of AR monitoring needed to mitigate risks.

We also recommend assessing if the monitoring team is adequately resourced to conduct a structured and detailed monitoring programme, with auditable working papers and adequate reporting of findings to the ARs. One way to check is to calculate the number of ARs monitored by each associate (we estimate 10 ARs per associate should be a maximum). In addition, check that a compliance committee is meeting a least monthly with sufficient management information to oversee adherence to the monitoring plan and ensure prompt escalation and remediation of breaches and findings from the monitoring

### 4. How is market abuse risk monitored?

The FCA highlighted adequate market abuse risk monitoring in its May 2019 “Dear CEO” letter. We recommend asking the principal firm if it has undertaken a comprehensive assessment to clearly identify its regulatory obligations under the FCA’s Market Abuse Regulation (MAR).

This assessment should inform the proactive monitoring of the trading activity of managed funds to detect and report suspicious orders and transactions. The FCA expects principal firms to adopt an automated monitoring system rather than a manual approach

### 5. How is AML and sanctions risk monitored?

Another reason to review the FCA register is to assess if the firm has appointed a dedicated MLRO (SMF17) responsible for financial crime oversight. Each AR’s ultimate beneficial owners (UBOs) and approved persons should be subject to daily screening for sanctions, politically exposed persons (PEPs) and adverse media, and any positive matches should be effectively assessed, escalated and remediated.

With the current levels of elevated sanctions risk, we further recommend checking if the firm has invested in technology that allows automated daily screening of sanctions lists so that new additions can be identified and remediated promptly to mitigate the risk of providing AR services to sanctioned individuals or entities

## Speak to IQ-EQ

IQ-EQ is the leading provider of regulatory hosting solutions and AR services in the UK. [Click here](#) to find out more about the services we offer, or get in touch with us directly:



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