

FCA Fires Warning Shot to Brokers in Wholesale Markets

Latest Dear CEO letter from the regulator includes strong criticism and warns that firms need to improve to meet regulatory expectations.

Key Points:

- FCA supervisory work during the next two years will focus on four key areas that the FCA considers require urgent attention.
- Firms should review the FCA's concerns carefully and take action now to address any areas in which they may not be meeting regulatory expectations.

The FCA has sent a [Dear CEO letter](#) to wholesale market broking firms, which strongly criticises relevant firms and their practices. The letter is not entirely clear as to whether it applies to wholesale brokers only, or all brokers operating in wholesale markets, but the issues are relevant to both and so should be taken into account by all firms in the sector. Although Dear CEO letters typically are critical in nature, in this instance the FCA uses particularly strong language to convey its dissatisfaction with firms in the sector, and therefore brokers operating in wholesale markets should ensure that they respond accordingly.

The FCA observes that it continues to see a “complacent attitude”, and a failure to meet expectations across all areas of regulation the FCA has examined recently. In the FCA's view, brokers in wholesale markets have made less progress than other sectors in embedding a culture of good conduct, and so action to raise standards across the sector has become “urgent”. The FCA considers that brokers have not kept pace with, and have under-invested in, the new requirements under MiFID II and MAR. In particular, the FCA notes that supervisory intervention, rather than firms' own initiative, has more often been the driver for recent improvements in compliance resourcing and systems and controls.

The letter was swiftly followed by a [further publication on payment for order flow](#) (PFOF), reporting on the FCA's recent supervisory work in this area. The report's findings are relevant to some of the concerns expressed in the letter, as discussed below.

What Issues Did the FCA Find?

The FCA explains that it has found four key drivers of harm, and that its supervisory strategy over the next two years will focus on these four areas.

Compensation and incentives

The FCA pinpoints poor and outdated remuneration models as a root cause of misconduct risk in this sector. In particular, the common “eat what you kill” remuneration model allows little or no room for firms to adjust compensation for non-financial performance measures, or to assess those measures in a fair and objective way.

The FCA is currently reviewing market practices in a survey of around 50 firms in the sector. According to the FCA, findings so far show a worrying lack of awareness of obligations around the awarding of remuneration and, in some cases, material non-compliance. The FCA plans to publish its findings later in 2019, and states that it will take a tough stance with firms in future.

Governance and culture

Due to the brokerage business model and the power of individual brokers within broking firms, the FCA considers that wholesale brokers should have strong governance frameworks and should be headed by effective boards. The FCA believes that the SMCR will form a key driver for change, and the regulator will work with firms to ensure that they implement the regime effectively.

Capacity and conflicts of interest

The FCA considers that firms generally are weak in identifying the particular capacity they are acting in for a given transaction. As a result, firms often do not ensure the necessary arrangements are in place to identify and address conflicts of interest. This issue is explored further in the FCA’s report on PFOF, which explains how firms have applied the rules inconsistently and sets out the FCA’s expectations.

The FCA stresses that it expects firms to implement the necessary systems and controls to enable themselves to identify, and apply the appropriate safeguards to, the particular service they are providing at a given time. The FCA highlights that, following the publication of its report on PFOF, it expects firms to be fully compliant in this area and will consider appropriate interventions if it identifies individual cases of continuing non-compliance.

Market abuse and financial crime controls

The FCA describes firms as being “complacent” about their responsibilities to monitor and mitigate market abuse and financial crime risk. Firms have demonstrated both a lack of understanding of these responsibilities and underinvestment in systems and controls, including surveillance systems and training. The FCA stresses the heightened risk of market abuse within wholesale broking, and expects firms to improve surveillance arrangements and senior management engagement.

The FCA has recently examined personal account dealing at a number of broking firms, noting poorly designed policies that do not meet FCA requirements, and worryingly low levels of personal account trades being reported. The FCA will be publishing findings of this work later in the year, and will be following up with individual firms at which the FCA has identified shortcomings.

Other considerations

The FCA also highlights the importance of technology, and states that it will continue to encourage firms to test their IT controls and pursue necessary improvements. In particular, the FCA has identified serious deficiencies in firms’ operational resilience and in their preparedness to combat cybercrime.

Further, the FCA expects senior managers to take responsibility for ensuring the firm's Brexit planning will allow it to act in the best interests of clients, and in line with regulatory requirements, in all possible Brexit scenarios. Firms need to keep the FCA closely informed of their plans.

What Next?

The FCA asks CEOs to consider and discuss the letter with their management board, in particular, how the issues the FCA has identified apply to their business. Firms should take steps to mitigate any issues that apply. The FCA will be engaging with firms in the sector during the next two years and implementing its supervisory strategy to effect change. The FCA plans to write to wholesale brokers again after March 2021 to communicate its updated views and to provide an updated supervisory strategy.

The FCA has also indicated in its [Business Plan for 2019/20](#) that it will focus on the control of inside information within corporate broking functions, and that its MiFID supervisory work will continue to concentrate on conflicts of interest in wholesale markets. These workstreams tie in with issues highlighted in the FCA's letter.

Although the FCA's supervisory strategy spans two years, firms need to be thinking about the issues raised and promptly correcting any areas that do not meet regulatory expectations. Firms should also reflect on the fact that the FCA uses the word "urgent" more than once in the Dear CEO letter.

The checklist overleaf outlines key topics and actions that firms could consider and address in order to meet FCA expectations.

Topic	Action	Complete?
Compensation and incentives	Review remuneration practices against the rules, and consider whether awards adequately take non-financial performance elements into account	
	Look out for the FCA's findings from its review of remuneration, and ensure any issues that apply to the firm are addressed promptly	
Governance and culture	Evaluate any conduct and culture initiatives within the firm, and consider whether these initiatives are having the right impact	
	Consider how misconduct is addressed within the firm (including non-financial misconduct)	
	Review board composition and effectiveness	
	Consider SMCR implementation planning and ensure this is on track	
Capacity and conflicts of interest	Ensure appropriate arrangements are in place to identify the capacity in which the firm is acting, and address conflicts of interest accordingly	
	Review the FCA's report on PFOF and ensure the firm is meeting the FCA's expectations	
Market abuse and financial crime controls	Review surveillance arrangements and consider whether these are fit for purpose, and how they could be improved	
	Review procedures for handling and controlling access to confidential and inside information	
	Ensure staff are appropriately trained and understand the risks and their obligations in relation to financial crime	
	Look out for the FCA's findings from its review of personal account dealing, and ensure any issues that apply to the firm are addressed promptly	
IT	Review recent investment in IT systems and consider whether improvements are needed	
	Test IT controls to check resilience and ability to deal with potential cyber-related incidents	
Brexit	Consider how Brexit planning will ensure fair treatment of customers and compliance with relevant regulatory obligations	
	Ensure that the FCA has been informed of the firm's Brexit plans	

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