

Consultation response

CP17/37: FCA Consultation Paper on Industry Codes of Conduct and Discussion Paper on FCA Principle 5

5 February 2018

The Association for Financial Markets in Europe (AFME) and UK Finance welcome the opportunity to respond to the FCA Consultation Paper on Industry Codes of Conduct (the CP) and Discussion Paper on FCA Principle Five (the DP). We have also consulted other industry bodies in the financial sector and are aware that IA, ICMA, ISDA and LMA are responding to the Consultation. We have had the opportunity to review their submissions in draft and we share many of the concerns they raise in their respective submissions.

Executive Summary

We support the highest standards of market conduct and have always welcomed moves designed to improve standards of market conduct. We recognise that the FCA's remit across financial services in the United Kingdom is vast and complex. We also understand that consumers and market participants look to the FCA for guidance and advice, including in the unregulated space.

However, the CP and DP raise a number of important questions and concerns, and we ask that the FCA revisit several key points in the proposals before proceeding further. These key points include:

- The distinction between codes of conduct applicable to regulated markets and those applicable to unregulated markets
- The process for the FCA to recognise and withdraw recognition of a code
- The distinction between recognised and unrecognised codes
- Conflict of laws and extraterritoriality issues
- The effect on code authors and their existing processes
- Supervision and enforcement

The FCA already has a broad set of supervisory and enforcement powers, and we are given to understand that the proposals set out in the CP and DP do not seek to change the FCA's current approach to supervision and enforcement. This is not explicit in the consultation and we request that the FCA confirms this.

Below, we set out our responses to the questions in the CP and DP. In some cases, the questions are duplicated, or the same or a similar question appears in more than one place in a slightly different format, and by the same token our answers may appear more than once. We would be happy to discuss any aspect of our response with the FCA.

We also recommend that the FCA consider the timing of this work and suggest that, if it proceeds, that it is delayed for a year or so. Firms have recently made significant IT and policy procedure changes resulting from recent regulatory change and the proposals as drafted suggest that additional changes may be required. Such delay would provide an opportunity for further consultation and discussion on these proposals.

We would like to thank the FCA for the considerable cooperation so far on this matter and would welcome further discussions and consultation as the FCA's thought processes on this subject evolve.

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Q1 Do you think we have been sufficiently clear about how we will view industry codes of conduct in our regulatory activities, including supervision and enforcement? If not, what further questions do you have about our general approach?

We are supportive of appropriate regulation as well as the drive to articulate clearer standards of acceptable conduct and trading practice by industry. We also recognise that there is a role for industry to play in setting the standards for markets and activities not covered by regulation. However, we are concerned with several aspects of the FCA's general approach, which include the proposal formally to recognise industry codes, and the criteria therefore to be used in formally recognising industry codes, for unregulated activities. We suggest that the FCA undertakes further consultation on this.

We make our response on the assumption that the FCA is asking for feedback on how it will view industry codes of conduct that are applicable to unregulated markets and unregulated activities when discharging its general functions. We note that paragraph 1.13 of the CP states that it is not intended to address or make changes to the FCA's regulatory approach towards codes that cover regulated markets and regulated activities, meaning that FCA confirmation of industry guidance on regulatory rules is likely to remain an infrequent occurrence.

We do not think that it is clear how the FCA will enforce industry codes of conduct or how this fits with its existing ability to use currently published material evidentially. In particular:

- The approach appears to be principles-based but applied in a rules-based way. The lack of detail on exactly which codes will be considered could make it difficult for regulated firms – and regulated individuals - fully to understand their regulatory obligations in respect of their unregulated activities.
- The FCA's handbook rules, guidelines and confirmed industry guidance by contrast, are a clear indicator of what firms and individuals are required to do, as well as how they are supervised by the regulator. The proposals do not fully explain how firms should treat recognised codes.
- An understanding of the status of published documents akin to codes but with different names (including but not limited to principles, guidelines, industry best practice, standards, and the like) would be helpful.
- We request that the FCA clarifies how it sees the difference between voluntarily-produced recognised codes on the one hand and regulation on the other.
- We welcome greater clarity on how the voluntary approach proposed by the FCA will apply in practice. This should include a statement that an individual or firm should not be held to account for non-adherence to a code to which the relevant firm has not become a signatory.
- We also welcome discussion with the FCA on what role the FCA thinks that trade associations should play in the code production and recognition process.

Q1A Do you agree that the FCA should support the take-up of industry codes through the general approach described? If not, how should the FCA consider codes for unregulated markets developed by industry practitioners?

As previously stated, we are supportive of appropriate regulation as well as the drive to articulate clearer standards of acceptable conduct and trading practice by industry. However, we are concerned with several aspects of the FCA's general approach, which include the proposal to formally recognise industry codes for unregulated activities. We suggest that the FCA undertakes further consultation on this.

The FCA's proposal, as drafted, is likely to provide (or be perceived as providing) recognised industry codes with quasi-regulatory status by enhancing the FCA's ability to enforce. The FCA references enforcement on a

number of occasions, including where the FCA notes that one of the goals it is intending to achieve in CP17/37 is to “enhance [its] ability to act against... misconduct by authorised firms and individuals” (CP17/37, 1.10).

In this way, the FCA risks conflating industry codes with regulation. We think this raises a number of practical issues that require further thought and consideration, such as:

- Possible benefits of industry codes in general, e.g. industry led efforts to improve standards towards ‘best practices’ rather than simply satisfy minimum regulatory requirements, may be lost if authors, conscious of codes obtaining quasi-regulatory status, are disincentivised to submit codes for recognition, or else draft defensive codes in light of the possibility that they may be submitted for recognition. Indeed, some issued codes/standards may need to be redrafted if they were to obtain such a quasi-regulatory status. The FCA already has a broad set of supervisory and enforcement powers. We are given to understand that the proposals set out in the CP do not seek to change the FCA’s current approach to supervision and enforcement, in particular that recognising a code will not enhance the FCA’s enforcement powers. This is not explicit in the consultation and we request that the FCA confirms this.
- Creating a new distinction between recognised and non-recognised codes establishes a ‘two-tier’ system of industry codes, risking ambiguity and confusion among market participants as to how such codes should be treated.
- Some industry standards are more principles-based, rather than providing granular definitions of conduct. It is unclear how these standards fit within an enforcement regime other than as evidence of performance at the required level. A firm meeting such a standard might argue that it is exceeding the required level, but it is less clear that it can be argued that a firm failing to meet such a standard is somehow falling below its regulatory obligations.
- Possible benefits of an FCA-recognised list, e.g. that it highlights material codes for market participants, are undermined by the FCA’s explicit statement that it ‘may still use an unrecognised code to inform [its] view of proper standards if [it] were to take enforcement action’ (CP17/37, 4.15). Thus, regardless of any FCA list, firms still need to be cognisant of all industry codes. This would substantially increase the regulatory burden on firms without a clear and proportionate benefit in the cases where a code may not be applicable to a firm’s activities.
- In addition to the aforementioned risk of a ‘two-tier’ code system, we welcome clarity on how the FCA proposes to treat existing codes that have not been written with the FCA’s proposals in mind and how such codes should be treated. As noted above, FCA recognition may require some codes to be redrafted taking into account the new regulatory status.
- We understand that FCA will not answer questions on recognised codes, noting that answering ‘interpretive questions’ is the responsibility of ‘the authors of the codes’. This approach may not be appropriate for all possible authors, such as trade associations but, if it is taken forward, will the FCA defer to the authors and judge compliance with the code based on the authors’ interpretations?

Extraterritorial scope: Many industry codes are written on a global basis and, while the CP does not address the issue, it appears that the outcome of the CP, as currently proposed, will have extraterritorial effect. Some Senior Managers and Certified Persons are resident outside the UK and subject to local laws. We also suggest that the FCA considers whether codes developed overseas are appropriate for UK markets and guidance on whether firms’ overseas entities will need to apply codes. There may be potential conflicts where the standards of a code are materially different from local practice or present a competitive disadvantage. It is not clear what would happen where home/parent regulators have applied a code in a different way, for example, where a firm has agreed with a regulator to apply a code to some business lines but not others.

- Enhanced enforcement ability: The FCA acknowledges that its ability to take enforcement action ‘is not affected if a code is not recognised’, i.e. a non-recognised code may still inform the FCA view of proper conduct. We suggest that if this work is an effort by the FCA to be more transparent in how it takes action against regulated firms in respect of activities outside of its traditional remit, that it is explained as such.

Q2 Do you agree with our proposal to recognise certain industry codes of conduct in unregulated markets? If not, please provide your reasons.

We do not consider that the CP has provided sufficient information to enable us to respond definitively to this question, while also noting a number of challenges, outlined particularly in our answers to QQ 1, 1A and 3, with the proposal as drafted.

We would welcome further clarity from the FCA on the recognition criteria and the interaction of recognised codes with supervisory and enforcement activity. Furthermore, we ask that the FCA provides a definition of “unregulated markets and activities” for the purposes of the proposal.

We would also ask that the FCA explains the areas of unregulated markets that it considers to be of concern (and why), and which existing codes it would seek to recognise, particularly as many of the standards being published by the FMSB cover regulated markets and as such are excluded from FCA recognition. AFME is aware of some 35 codes, so a steer on which codes the FCA is considering recognising would assist firms in their planning and preparation. We would also welcome further clarity from the FCA on the intended benefit to firms and individuals of complying with recognised codes.

Q3 What challenges do you foresee for us or industry with recognising certain industry codes?

As stated we are supportive of moves designed to improve market conduct. We have a number of points to make at this stage, but others may follow as the proposals become clearer.

- There might ensue a two-tier approach both to the status of codes as well as to regulated and unregulated market participants operating in unregulated markets. With regard to the status of codes (i.e. recognised versus unrecognised) this could lead to the potentially unhelpful implication that unrecognised codes are less important.
- In respect of regulated and unregulated market participants operating in unregulated markets, whilst regulated firms are already subject to PRIN 5 and SM&CR (where applicable), the FCA recognition of codes could increase the disparity of the operating regime which regulated firms have to operate under in these markets, thereby impacting competition. Codes cover regulated and unregulated activity (often as part of the same requirements) and is not clear how codes that have broader application across regulated and unregulated business will be enforced.
- For firms there will be additional costs for compliance and legal teams in contributing to the drafting of codes and in monitoring compliance with them.
- Despite their best efforts, unless there is an agreed publicly available and regularly updated list, firms may not have a clear line of sight of all potentially applicable codes. Many codes are produced overseas and there may be challenges for the FCA in recognising these codes.
- There are level playing field and regulatory arbitrage questions given that the FCA is one of the first regulators implementing this approach, and for regulated firms who compete with unregulated competitors in unregulated markets. How will the FCA will decide whether to recognise codes in respect

of areas where there are multiple applicable codes, or where codes are not accepted by the market participants as representing a proper standard of conduct?

- Existing codes will not have been written with the FCA's proposals in mind and thus it is not clear how such codes should be treated. FCA recognition may require some codes to be redrafted taking into account the new regulatory status.
- If the proposals proceed, the FCA should consider measures to ensure that code producers create codes that do not increase barriers to entry to markets or discriminate against certain market participants. We note that smaller firms may be at a disadvantage compared to larger firms as the proposed approach may be particularly burdensome for them. There is also a risk that authors (be they bodies, trade associations, or individual firms) submit codes for recognition in their own interests (as opposed to the interest of the broader market). The FCA should consider providing prior notice to the market of codes it is considering for recognition, thus allowing market participants to object if necessary. This would provide a degree of additional governance.

Q4 Do you agree with the proposed changes to the FCA Handbook designed to give effect to our proposals? If not, please provide your reasons.

The proposed changes need in our view to be reconsidered after a further period of consultation and discussion. At least, they need to make explicit that recognising a code will not increase its enforceability; and if the intention is that compliance should create a 'safe harbour' or act as a 'shield'. We make the following initial points:

- The definition of "FCA recognised industry code" in the new draft Annex A does not appear to be restricted to unregulated activities.
- The definition of "unregulated activity" in the FCA Handbook, - "an activity which is not regulated activity" - is too wide and needs to be restricted to financial services, at least.
- The new draft DEPP 6.2.1 G (4A) is insufficiently clear to represent a useful safe harbour. The words "tend to indicate" should be replaced by "confirm" and the word "usually" should be deleted. In practice we do not see why there should be any difference in safe harbour terms between FCA confirmed industry guidance on regulatory rules and FCA recognised industry codes for unregulated markets.

Q5 Do you agree with our proposed process for recognising certain industry codes? If not, how should we amend it?

We think it important that no code should be recognised unless it has been through a full process of public consultation. Currently, codes are produced with varying degrees of consultation, but none with a level of consultation that we believe to be appropriate for where a breach may potentially lead to enforcement. In addition:

- We are unclear whether the proposal is that code authors would be required to work together with the FCA in drafting codes and/or seeking approval of their content. The FCA may need to assume a stronger role in ensuring fairness of representation, providing early feedback to facilitate recognition or brokering compromises.
- We note that currently code authors do not always involve all relevant stakeholders. We suggest that the FCA should provide prior notice to the market of codes it is considering for recognition, thus allowing market participants to comment if necessary. This would provide a degree of additional

governance and would prevent codes being submitted and recognised by the FCA that are not representative of a particular market or activity.

- We suggest that where a code has been considered and ultimately rejected for recognition, that the FCA issues a regulatory notice notifying the market accordingly.
- We believe that there is a need for transitional periods before an FCA recognition becomes effective or is withdrawn or updated, so as to avoid a ‘cliff edge’ for firms who are trying to become compliant and/or need to depart from an existing compliance approach. The three-year period for recognition may be better framed as a flexible period rather than as a single fixed period applicable to all recognised codes.
- We understand that the FCA will not recognise any code without the consent of the code producer. We welcome further information from the FCA on how this might work in practice.
- We think there is a risk that the code recognition process might become as time-consuming and resource-intensive as introducing regulatory rules thus stifling the production of codes.

Q6 Do you agree with the criteria proposed for deciding which codes to recognise? If not, what additional or alternative criteria should we consider?

Please see our responses to QQ1-5 above.

Q7 Do you believe the FCA should consider extending the application of Principle for Businesses 5 (A firm must observe proper standards of market conduct) to unregulated as well as regulated activities? If not, please state why.

We are comfortable with the FCA considering this extension of application, but our view is that the FCA’s recent enforcement action against firms and individuals in the recent LIBOR and FX scandals has demonstrated its ability to bring successful enforcement actions in the unregulated sector using its existing powers, which have also clearly been augmented as a result of the extension of the scope of the market abuse regime effected under the Market Abuse Regulation and the implementation of the Benchmark Regulation.

We would, therefore welcome further consultation with and information from the FCA on the case for this extension before any decision is made on whether to proceed to a consultation paper.

Q8 What benefits, and challenges do you believe this would pose to FCA authorised firms, the FCA or financial markets more generally?

Please see our response to QQ1-7 above.

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