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Dear Nicky

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Our Ref: SA171101D

Re: FCA powers and perimeter

I am writing to you following our appearance at the Committee on 31 October. During the session Mr Mann asked if I could write to you regarding the powers we do not have that it might be useful for the Committee to consider whether we should have. The question was framed around RBS Global Restructuring Group (RBS GRG) but also more broadly. Mr Mann also asked me to set out what we have been doing on areas outside our regulatory perimeter.

This letter sets out an overview of what the FCA regulates, the aim of regulation, the powers available to us, and specific examples of areas where issues have arisen about the nature and extent of the FCA's role. I hope this will provide helpful context for some of the questions we have grappled with in the past. I also set out the steps we have taken to explain our understanding of the FCA's remit where there is less clarity about the role we should play.

What the FCA regulates

Certain types of financial services activity require a license or "permission" before they can be carried on. The definition of these activities, and the "specified investments" to which the activity relates, is at the heart of FCA regulation.

The activities are described at a high-level in the Financial Services and Markets Act 2000 (FSMA), and in more detail in the Financial Services and Markets Act 2000 (Regulated Activities) Order (the RAO). We usually refer to such activities simply as "regulated activity" or as being within the "FCA's perimeter".

Much of the regulatory framework set out in FSMA, and most of the FCA's powers, are targeted at regulating the conduct of this activity. Persons licensed to perform such activities are "authorised persons". Obvious examples of regulated activity are giving advice on whether to invest in particular securities or, since 2014, providing consumer credit. Performing such activities without an FCA permission is a criminal offence.

The regime set out in FSMA and in the RAO governing "regulated activity" is not, however, the only basis for the FCA's regulatory responsibilities. The FCA performs the role of the UK's listing authority. The listing regime applies to firms whether they are authorised under FSMA to conduct regulated activities or not; and in fact the majority of listed companies are not FCA authorised firms. Another example is the market abuse regime which applies to behaviour conducted by any person irrespective of whether they are authorised by the FCA.

We are also responsible for regulating some entities or conduct under standalone legislation outside the FSMA framework altogether. The Payment Services Regulations, for example, set out a separate regime for registering or authorising payment service providers, and give the

FCA a different set of responsibilities and powers. Similarly, the Money Laundering Regulations 2017 specify responsibilities for the FCA which extend beyond those for authorised firms conducting regulated activities.

Finally, as of 1 April 2015 the FCA became a competition regulator. The FCA has a specific objective to promote competition in the interests of consumers (I cover this in more detail later), and has also been given what are usually referred to as “concurrent competition powers” available to the Competition and Markets Authority (CMA) and other sectoral regulators. Such powers may be exercised in respect of “financial services activity” rather than being tied to the more specific and narrower concept of “regulated activity” from the RAO.

The decision as to what or whom should be regulated by the FCA is of course one for Government and Parliament. Often the choice will be made for domestic policy reasons, such as the transfer of consumer credit from the Office of Fair Trading (OFT) to the FCA in 2014. At other times EU legislation has shaped whether and how a financial service should be regulated; it then falls to Member States to decide which body within their jurisdiction should be the national competent authority for the activity in question. The Payment Services Directive and the Benchmark Regulation are two examples of recent EU legislation which have resulted in additional responsibilities being given to the FCA.

Why we regulate

The FCA’s aim and purpose is set out in FSMA. We have a single strategic objective – to ensure that relevant markets function well. The strategic objective is underpinned by three statutory “operational objectives”:

- to secure an appropriate degree of protection for consumers;
- to protect and enhance the integrity of the UK’s financial system; and
- to promote effective competition in the interest of consumers.

Many of the FCA’s core powers, especially the rule-making power, require that action by the FCA should be to advance one of these three operational objectives. A key concept is the meaning of “consumer” for these purposes. The definition in FSMA is broad, but it does not extend to all consumers of all products. Rather, the emphasis is upon persons who use, may use, or have used, regulated financial services or have invested, or may invest, in relation to financial investments. This is something we have to consider both when making rules and if we contemplate firm-specific action to further our consumer protection objective.

In pursuing the aims set out in the statutory objectives, we are concerned not only with the behaviour of the firms we regulate, but also - at least for the firms authorised only by the FCA - their financial health. In this sense, we are both a conduct regulator for 56,000 firms and a prudential regulator for 18,000 firms. The FCA prudentially regulates those firms for which such regulation applies that are not regulated by the Prudential Regulation Authority (PRA).

How we regulate

The FCA’s powers are extensive, but the availability of the powers, and how we use them, will depend on who and what it is we are dealing with. In particular, it will depend upon whether the person in question is an authorised firm (that is, a person given permission to carry on regulated activity), an individual at such a firm, or a person subject to our criminal prosecution powers or our competition law jurisdiction.

Authorised firms

To carry on regulated activity at all, a person must satisfy us that they meet the "threshold conditions" set out in FSMA. This provides us with the opportunity to assess their suitability at the "gateway", and impose requirements or restrictions upon how they carry on the relevant activity. Among other things, we look at whether a firm's business model is viable and the firm is suitable to carry on regulated activity.

These threshold conditions also apply on a continuing basis to authorised firms, and therefore are the minimum standards a firm is required to satisfy. The unregulated activities of a firm may be relevant to whether that firm continues to meet the threshold condition on suitability which requires that the firm must be fit and proper. Whether this is the case or not will depend very much on the particulars of the firm's conduct. The conduct in question would need to be sufficiently serious before it called into question the firm's ability to meet this condition.

Once a firm is authorised, we can:

- write rules governing their conduct;
- impose requirements on individual firms that they do or do not do specific things;
- investigate them if circumstances suggest that they have broken our rules, and impose financial or other penalties if we conclude that they have done so;
- require that "skilled persons" report on aspects of the firm's business.

We can make rules only if they advance our operational objectives. Importantly, the power allows us to make rules governing unregulated activity by authorised persons. This means that we have some regulatory oversight of activities which do not themselves require authorisation. As explained above, one of the constraints on the exercise of the power in the context of consumer protection has been the need to consider whether "consumers", in the sense defined in FSMA, are the object of any intended protection.

The FCA's Principles for Businesses are 11 high level rules which apply to all FCA regulated firms. They include requirements that firms must conduct their business with integrity, exercise reasonable skill and care, treat their customers fairly, and observe proper standards of market conduct. With three exceptions, the Principles are directed at firms' conduct in respect of regulated activity. The exceptions relate to:

- the adequacy of a firm's financial resources (Principle four);
- the adequacy of the firm's systems and controls - to the extent that these are likely to have a negative effect on the firm's ability to satisfy the threshold conditions or the integrity of the UK financial system (Principle three); and
- the duty to deal with the FCA in an open and co-operative way (Principle 11).

The fact that these three Principles extend to all of a firm's activities provides the FCA with some regulatory grip over everything that a firm does; but the breadth of the rules is not intended to dissuade the FCA from its focus on the regulated activities of a firm and the detailed rules governing such conduct. We do nonetheless look to the Principles when we are concerned about how firms behave "outside the perimeter". This was the case, for example, when we took action in respect of the LIBOR (London Interbank Offered Rate) manipulation and in respect of firms' foreign exchange practices.

Individuals

FSMA requires that individuals performing “controlled functions” within authorised firms must be approved by the regulator. The FCA’s (and PRA’s) role has been to designate these functions, assess whether individuals are fit and proper to perform the functions, and take disciplinary action against individuals who break the regulators’ rules.

For the most part, the FCA’s ability to take action against individual “approved persons” has been limited to conduct within the scope of the particular function for which they were approved (unless the individual was “knowingly concerned” in the breach of rules by a firm). With the introduction of the Senior Managers and Certification regime (SMCR), this is changing.

The SMCR asks that the regulators concentrate on the assessment of the suitability of senior managers at the gateway; but allows the regulators to extend rules governing individuals’ conduct beyond those who have been vetted by the FCA (or PRA). The FCA’s conduct rules for banks apply to senior managers, certified persons and other non-ancillary staff. Once the SMCR is extended beyond banks to all firms, we propose to adopt a similar approach.

One of the key differences under the SMCR is that the conduct rules are not limited to an individual’s behaviour only in relation to the regulated activity carried on by the firm. They can also apply to conduct in relation to the firm’s unregulated activity. The rules require, among other things, that individuals act with integrity, that they have due regard to the interest of consumers, and that they observe proper standards of market conduct.

Senior managers are also required to comply with four additional conduct rules:

- take reasonable steps to ensure that the business of the firm is controlled effectively;
- take reasonable steps to ensure that the business of the firm complies with the relevant requirements and standards of the regulatory system;
- take reasonable steps to ensure that any delegation of responsibilities is to an appropriate person and that this is overseen effectively; and
- disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

Under the SMCR’s ‘overall responsibility’ requirement, firms need to ensure they assign overall responsibility for all business areas to a senior manager, including those in unregulated markets. They must then operate their business in line with our rules, including putting in place governance, systems and controls to ensure this.

Setting the boundary: where the perimeter lies

I set out below some of the areas where there have been calls for the FCA to intervene, questions asked about the extent of FCA involvement or action, or where uncertainty has arisen. These are not intended to be exhaustive examples, but rather to illustrate how questions have arisen about the scope of FCA regulation.

Bank activities outside the perimeter - GRG and “embedded swaps”

In contrast to mortgage lending and consumer credit activity, commercial lending is not a regulated activity. In other words, a person lending money commercially does not need to be authorised by the FCA (unless the lending constitutes “consumer credit”). So some lenders are therefore completely outside the scope of FCA regulation. Banks, on the other hand, are

regulated by the FCA (because they are deposit-takers), but the FCA's interest is primarily in the extent which the banks' activity outside "the perimeter" is relevant to the banks' standing as a deposit taker. This is consistent with the scope of the FCA's Principles, and the fact that the FCA will look at a firm's financial resources, its systems and controls (to the extent that they reflect on the fitness of the firm itself or adversely impact the wider financial system), and the firm's relationship with its regulators, even where concerns might arise from unregulated activity.

The extent of the FCA's responsibility for the unregulated activity of banks has nonetheless been the subject of public debate and scrutiny.

RBS GRG

During my appearance at the Committee in October, I explained some of the complexities around GRG and our perimeter. Engaging in the sort of restructuring activity conducted by GRG is not of itself regulated activity. Our detailed conduct rules on the design and governance of products and services do not apply. The initial allegations about the conduct at GRG were, however, sufficiently serious to raise questions about RBS beyond the immediate business area. We took the view therefore that - despite the fact that the conduct in issue was unregulated - the test for the appointment of a 'skilled person' under section 166 FSMA was met.

As I explain above, the SMCR will promote greater accountability within regulated firms in future, even in respect of unregulated activity. The SMCR cannot be applied retrospectively, but we would expect the new framework to assist with a GRG type scenario in the future.

Embedded swaps

Commercial loans with marked to market break costs, sometimes known as embedded swaps or "tailored business loans", provide another illustration of the issue. Again, these are not regulated products, but they do have similar characteristics to interest rate hedging products (IRHPs). After the FSA agreed the IRHP redress scheme with the banks, there were calls for the banks to extend the scheme to commercial loans of this type.

In a letter to the Committee on 26 April 2014, our General Counsel, Sean Martin, set out in detail why these types of loans do not sit within the regulatory perimeter: www.parliament.uk/documents/commons-committees/treasury/140626_Sean_Martin_to_Andrew_Tyrie.pdf

Crypto-currencies

Crypto-currencies are not 'specified investments' for the purposes of the RAO. This means that typically the issuing of, or trading in, a cryptocurrency itself will not involve regulated activity. However, derivatives which reference a cryptocurrency (such as a future, or a contract for difference based on a particular cryptocurrency) are capable of being regulated investments. So trading, arranging or advising activities related to cryptocurrency derivatives can amount to regulated activities.

Since the increased public awareness of certain cryptocurrencies, including Bitcoin, there has been discussion about whether the FCA should regulate this sector. I have spoken publicly of my concerns regarding cryptocurrencies, and that investors should be prepared to lose their money if they invest. Cryptocurrencies are not a secure investment given the volatility in the pricing of the asset and the limited nature of its liquidity.

Spot FX

Spot FX transactions where the exchange of currencies takes place within two trading days are not regulated investments for the purposes of the RAO.

The serious concerns about conduct in the foreign exchange (FX) markets were, however, one of the drivers for setting up the Fair and Effective Markets Review (FEMR). The FEMR recommendations published in June 2015, and the subsequent work of industry and central banks under the auspices of the Global FX Committee, led to publication of the FX Global Code in May 2017. This is a new industry code that sets out global principles of best practice for the Wholesale FX Market.

The FCA contributed to the preparation of the Code, drawing in particular on deficient practices identified as part of our supervisory work. I will set out later how our proposals on industry codes of conduct could support similar initiatives in the future.

Funeral Plans

Generally the regulation of pre-paid funeral plans, as opposed to regulated insurance products, also falls outside the FCA's remit. While the authorisation and registration of funeral plans is a regulated activity under the RAO, there are exclusions that apply if certain conditions are met.

Broadly speaking, the exemption applies if the funeral plan is set up under a trust, or if the funeral plan provider applies the sums paid under the plan to a whole of life insurance policy with a regulated provider for the purposes of providing the funeral. Funeral plan providers that meet these criteria are subject to a self-regulatory regime under the Funeral Planning Authority (FPA).

We understand that all relevant funeral plan providers use these exclusions. No funeral plan provider is authorised and regulated by the FCA. We liaise with the FPA on perimeter matters as appropriate.

Investment consultants

Investment consultancy services provide another example of a concern arising from the delineation of the perimeter. In June 2017 we published the findings from our Asset Management Market Study, which identified weak competition in the market. The Final Report is available on our website: <https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>.

In particular, we found that pension trustees have limited ability to assess the quality of the advice they receive from consultants. There are also relatively high levels of market concentration and barriers to expansion which restrict smaller or newer consultants from developing their business. We also found that vertically integrated business models were creating conflicts of interest.

Investment consultants play a significant role advising pension fund trustees when they are procuring asset management services. There are areas of investment consulting that are not regulated by us but still have a significant impact on returns for investors, such as strategic asset allocation advice. Therefore, to allow a complete assessment, and to enable any remedies to cover the whole market, we referred the sector to the CMA for a market investigation.

Subject to the findings of the market investigation, we have recommended HM Treasury bring the provision of investment consulting and employee benefit consulting asset allocation advice within the FCA's regulatory perimeter.

Unregulated mortgage purchasers

There are three regulatory activities relating to mortgage lending: "entering into", "administering", and advising on a regulated mortgage contract. Mortgage lenders who "enter into" a regulated mortgage contract are able to transfer the ownership of those contracts or the rights under them to other entities, often as a funding source. The regulatory framework does not require the purchasing entity to be regulated, as long as they employ an authorised third party to "administer" the mortgage contracts. However, the administering activity is narrowly drawn, essentially amounting to notifying the consumer of interest or payment changes, or taking necessary steps to collect or recover payments due.

This potentially exposes consumers to harm if, for example, an unregulated entity were to charge higher interest rates to captive borrowers, not reduce rates in a falling market, or treat customers in arrears unfairly. As you may recall, the Public Accounts Committee raised this area as a point of concern in the recent asset sale undertaken by UK Asset Resolution (UKAR) to Cerberus. Depending on the regulated status of the purchaser of the book, there is the potential for consumers to be exposed to greater harm. There is also a risk that this harm might not be apparent to us because when mortgages are sold to an unauthorised entity, the new owners are not subject to our reporting requirements and so we have no way of knowing how these loans are performing in terms of arrears and repossession levels.

Perimeter complexities - British Steel Pension Scheme (BSPS)

Recently we have seen the complexities of navigating the regulatory perimeter brought into the spotlight due to BSPS, along with restrictions on the action we can take.

The regulation of pensions falls to a number of different bodies – the FCA regulates primarily defined contribution pensions, whereas the Pensions Regulator (TPR) regulates defined benefit pensions. There are also other schemes that fall within the Government's direct remit, but the FCA and TPR are responsible for the majority of the pensions market.

The BSPS is a defined benefit pension scheme and is regulated by TPR. The FCA has no role or oversight of BSPS, or any other defined benefit pension scheme – such as the BHS or Carillion schemes. However, we do regulate financial advisers – including those providing pension transfer advice to BSPS members.

We became aware of reports that financial advisers were potentially providing poor advice to BSPS members resulting in them transferring out of their defined benefit pension scheme. This had potentially far reaching implications, including the loss of safeguarded benefits, such as a guaranteed income.

We therefore took swift action in respect of the advice being provided to BSPS members. Despite this, some stakeholders have suggested that we should have done more. They argue that we should have provided better communications to BSPS members about the choice they face, provided advice directly to BSPS members, or extended the relevant deadlines. None of these actions fall within our remit and we have no legal power to take such action or require the TPR to do so. We have however been working closely with TPR and The Pensions Advisory Service (TPAS) to ensure that BSPS members are able to obtain helpful advice and guidance and that their interests are properly protected.

Unregulated introducers

Also relevant to the BSPS example is an issue relating to unregulated introducers. As explained above, the RAO defines what a regulated activity is, but the RAO also exempts some specific activities from FCA regulation. One such exemption applies to certain types of introducers.

Article 33 of the RAO excludes individuals or firms from needing FCA authorisation where they introduce consumers to an advice firm, but the introduction must be made to a firm offering independent, regulated advice or the exemption will not apply.

Introducers that find potential customers for independent financial advisers, advisory stockbrokers or independent investment managers, are allowed to receive a payment for making introductions.

Where we have concerns with unregulated introducers is where they may exercise influence over a regulated adviser. We published an alert in August 2016 which highlights some of the risks arising from authorised firms accepting business from unauthorised introducers; and we recently reminded pension transfer advisers of their obligations when dealing with unregulated introducers.

Ultimately, introducers are legally permitted to carry out the activity because they are outside the FCA's perimeter – as such, despite our concerns, if they are not breaching the legal exemption we are unable to take any direct action against them.

Limits to our powers - redress schemes to benefit SMEs

Questions about the extent of the FCA's remit, or the adequacy of our powers, do not always arise because of the scope of "regulated activity" set out in the RAO. A separate issue arose in the context of IRHPs relating to the FCA's power to require an industry-wide redress scheme.

FSMA gives the FCA the power to require regulated firms to establish and operate an industry-wide redress scheme under section 404 where the failure by firms would otherwise have given the consumer a right of action in court. Where the action relates to a breach of an FCA rule, rights of action under FSMA are limited to "private persons". Incorporated businesses are therefore excluded in industry-wide consumer redress schemes based solely on a breach of our rules. As many of the customers affected by the mis-selling of IRHPs were SMEs, this limited the action we could take to secure compensation for them.

Exercising our formal powers to make an industry-wide redress scheme under s404 requires the FCA to undertake a public consultation and to put in place procedural rights for firms. This does mean that in complex cases, like IRHPs, securing formal redress would be likely to take a considerable length of time.

The Financial Services Authority's, our predecessor organisation, approach for IRHPs was to agree a voluntary scheme with the banks in 2012. This was established more quickly, and reached more of the affected businesses, than a formal scheme could have done. In addition a formal scheme would likely have encountered issues with limitation periods while the voluntary scheme extended back to December 2001.

The perimeter - our approach in future

The challenges arising from the scope of the regulatory perimeter - in terms of deciding upon our own focus and in communicating our role to external stakeholders - encouraged us to

address these issues openly and candidly when we consulted on the FCA's proposed Mission statement. We acknowledged the inevitable complexity which arises when a firm's activities extend into both regulated and unregulated activity. After consultation on the proposed statement of our approach, we said this:

"Financial services markets are dynamic, so defining where and how we might act outside the perimeter is not simple. But we are more likely to act where the unregulated activity:

- is illegal or fraudulent,*
- has the potential to undermine confidence in the UK financial system,*
- is closely linked to, or may affect, a regulated activity.*

Where we cannot act, we will clarify publicly why the issue falls outside our remit, or why our powers are limited, and raise this with Government and other relevant bodies.

We will also work with industry to help create industry standards that span activities outside the RAO. These standards can be a useful way for the industry to police itself in support of our regulatory work, and can help firms to communicate expectations of individuals when linked to the Senior Managers and Certification Regime."

The full Mission document can be found on our website at the following address:
<https://www.fca.org.uk/publication/corporate/our-mission-2017.pdf>.

The explanation about the circumstances in which the FCA is more likely to act in respect of unregulated activity reflects the current drafting of the FCA's Principles. But the text also reveals our appreciation of the importance of articulating clearly when and why we will take action in respect of unregulated activity and when and why we will not.

SMCR and industry written codes

The Mission refers to the FCA's proposed work with industry on industry standards as part of our intended approach towards conduct outside the perimeter. I thought it would be helpful to say a little more about this.

A key issue identified by the FCA, HM Treasury and Bank of England from FEMR was that there is little incentive for firms to comply with voluntary codes. And further to that, many codes lacked methods to ensure compliance. This is something we are conscious of, and as such in November 2017 we published our Consultation Paper on Industry Codes of Conduct. This can be found on our website at: <https://www.fca.org.uk/publication/consultation/cp17-37.pdf>.

Our consultation sets out how the SMCR can help support voluntary industry written codes of conduct and standards. For example, the SMCR requires firms to assess the fitness and propriety of their staff for particular roles and activities whether regulated or unregulated. And, as explained above, the SMCR's individual conduct rules apply to both the individual's conduct in regulated and unregulated activities. The industry code or standard could therefore form the basis for the firm to communicate its expectations in order to assess their staff's fitness in line with the requirements of the SMCR, and whether their behaviours meet the standards of the individual conduct rules.

We also propose to give formal recognition to certain codes and standards in unregulated markets, such as lending codes, as meeting our expectations on proper conduct. This will help

raise awareness and improve accountability for conduct issues, including where poor conduct in unregulated markets has an effect on regulated markets.

In our view, these proposals are proportionate and supportive of industry efforts to improve conduct in areas where we do not have powers to act.

SME consultation

As already stated, the majority of commercial lending remains unregulated. This is in part to recognise that businesses are generally considered to be more sophisticated than individual consumers. It also, in part, reflects the Government's wider policy objective of ensuring businesses have the greatest possible access to finance. However, we recognise that not all businesses are the same.

In reality many SMEs behave in a similar way to individual consumers when buying and using financial products, for example when taking out credit. They can therefore also experience similar types of harm, such as entering into an unsuitable product, receiving poor customer service or suffering financial loss. The RBS GRG case is an example of the potential impact this can have on SMEs in particular.

Although the FCA's powers in relation to commercial lending are limited, the Financial Ombudsman Service can consider some disputes about financial products and services we do not regulate, including lending to businesses. There are, however, restrictions that mean the Ombudsman Service cannot always consider complaints brought to it by businesses – many of which are SMEs. This includes, for example, where the SME is too large to meet the eligibility thresholds for the Ombudsman Service or where the value of their dispute significantly exceeds the Ombudsman's binding award limit of £150,000.

On 23 January we published a consultation on changes to our rules to allow more SMEs to refer complaints to the Ombudsman Service. We believe our proposals will make a significant difference to a large number of SMEs. Over time, our changes will contribute to better service to SME customers, leading to fewer complaints and better outcomes for SMEs.

The consultation paper is available on our website and we are accepting responses to our proposals until 22 April 2018: <https://www.fca.org.uk/publications/consultation-papers/cp18-3-consultation-sme-access-financial-ombudsman-service>.

Conclusion

I hope that this letter has provided a fuller explanation of the parameters for the FCA's regulation than was possible when I appeared before the Committee last year. And in particular that the illustrations of how the RAO operates, and the FCA's approach to concerns about firm conduct outside "the perimeter", demonstrate that we seek to strike a balance between:

- (a) focusing on the conduct that Parliament has identified as subject to full regulatory scrutiny; and,
- (b) ensuring that firms and individuals licensed by us behave responsibly, even in areas where their activities are outside the core jurisdiction of the regulator.

Where to draw the boundary between regulated and unregulated activities is a decision for Government and Parliament, not the FCA. I believe that it would be wrong for the FCA to ignore the distinction between regulated and unregulated activities. To do so, and seek to

regulate all the activities of an authorised firm in the same manner, would be to ignore the clear choice expressed in legislation about the degree of regulatory scrutiny expected.

I do believe however that the approach described in the FCA's Mission, and the increased regulatory oversight we will enjoy over the senior management of firms in the future, will provide a firmer foundation for FCA intervention outside the perimeter than has been possible in the past.

Yours Sincerely
Andrew

Andrew Bailey
Chief Executive