Martin Wheatley
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

21st February 2013

Dear Mr Wheatley,

The Chartered Financial Analyst Society of the United Kingdom (CFA UK) welcomes the opportunity to respond to the consultation 'Journey to the Financial Conduct Authority (FCA)'. This response has been prepared by CFA UK's Professional Standards and Market Practices Committee (PSMPC). The PSMPC has also used this response to touch on matters related to recent FSA initiatives on asset manager conflicts, sales practices, the banning of unregulated collective investment schemes (UCIS) and the wealth management thematic work. Hence why this submission is presented after the deadline stated.

<u>About CFA UK and CFA Institute</u>

CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

Members of CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct (enclosed). Since their creation in the 1960s, the Code and Standards have served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its societies.

Response to the consultation "Journey to the FCA"

CFA UK expressed major concerns in its position paper "Effective Regulation" and previous responses[1] related to the new regulatory regime. CFA UK was concerned that the new regulatory regime would not learn from regulatory history, continue to be symptom-led, lack the ability and willingness to act; and retain a philosophy that relies on standard paradigms.

There is much to commend the approach set out in the consultation -

1) Acknowledge that the duty of care should be the same regardless of how the client is classified. Caveat emptor or 'buyer beware' is no longer an acceptable defence.

2) More emphasis on supervision and enforcement

3) Recognise the role played by senior management with regard to the governance of a firm and how this influences its conduct.

[1] The full list of responses available to the public can be found at https://www.cfauk.org/about/advocacy.html

4) Emphasis on root causes rather than be symptom-led.

5) Recognise the role of product governance.

6) The willingness to act promptly and with courage even if the action is "unpopular".

7) Using the insights from behavioural economics.

However, despite the areas that give us some cause to be positive, the FCA will need to reassure our members that it is able to deliver on its intentions. We have been here before when a new regulator sets out its vision and intentions to address issues before significant detriment arose; only to fall short when it mattered most. The following quotes convey why the FCA and Prudential Regulation Authority (PRA) will need to do more to demonstrate that they will actually fulfil their role so that market integrity is enhanced and consumer detriment is limited.

"Our new regulatory approach will be proactive and preventative, aiming to head off problems in advance." (Howard Davies, FSA Chairman, 2000)[2].

"We can do a lot better job than in the past... There were warnings, from this institution (Bank of England), some from the FSA, many from abroad, and yet no one picked up the warnings and ran with them." (Paul Tucker, 2011)[3]

"We will step in earlier, and act faster, when we identify problems that risk harming consumers or the integrity of the market." (Journey to the FCA 2012)

Despite the themes that provide us with cause to be more positive about the FCA, we still have concerns over a number of key areas.

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2 http://www.fsa.gov.uk/Pages/Library/Communication/PR/2000/009.shtml

3 http://www.bbc.co.uk/news/business-13782849

Use of FCA resource

We believe that it is essential that the FCA has adequate resource to achieve better regulation. CFA UK has long been concerned that the FCA will not have the quality and quantity of resources to fulfill its many disparate roles and objectives. It is a concern that the FCA appears to be seeking ways to minimise the strain on resource in ways that could impede its ability to anticipate problems. We note that the FCA is looking to focus on the conduct at the very top of firms. We do not dispute that senior management set the culture of firms, however senior management are also most likely to understand the answers that the FCA wants to hear. It would be through interaction with those with day-to-day responsibility for clients, product design or risk management that one would better determine what the actual culture of a firm is.

We cannot but wonder whether, given adequate resource, the FCA would accept an objective of managing the consequences of, rather than reducing the probability of, failure.

Evidence

We welcome the evidence cited in the document especially how the FCA may have identified an issue like Payment Protection Insurance (PPI) much earlier than it was by the FSA. Conversely, evidence to demonstrate how the new regulatory framework would have been better equipped to address the root causes of the crisis is absent. What would have been more valuable would have been an example to demonstrate how the new regulatory framework would have reduced the risks of the recent crisis. Specifically, the FCA's role in addressing governance and conduct failings that contributed to undermining of trust in the financial sector.

The evidence that is cited provides two insights that need to be taken into account –

1) The examples demonstrate what happens when a regulator fails to act or does not act in time.

2) The examples also underpin our long-held view that to enhance market integrity and limit consumer detriment, effective supervision and enforcement is vital. The regulatory "successes" that have come to light can be attributed to better supervision and enforcement of existing rules and frameworks rather than a testament to a new

framework and rules. Had such efforts been made during the tenure of the tripartite system perhaps the crisis may have been less damaging.

Competition

The FCA's aim with regard to competition should be to focus on the quality of suppliers rather than the quantity. This would also mean that the FCA should be vigilant to ensure firms do not abuse their market power. However, this does not mean that every firm that enjoys a dominant position would exploit its competitive advantage.

The Journey to the FCA document expresses concern over a company using its greater knowledge and understanding of products and markets for competitive advantage. We found this rather perverse - it is surely good and right that a firm strive for a better understanding of its market. What is commercial and what is an unreasonable exploitation of a competitive advantage needs to be made clear, and should not act as a disincentive to becoming a market leader.

We do wonder, however, whether the proposed approach to monitoring each of C1, C2 and C3 firms will result in an uneven playing field, with smaller firms subject to lighter-touch regulation. In reading the proposed approach to regulating C3s, one cannot help but wonder whether the FCA has adequate resource.

Integral to ensuring that the quality of suppliers remains high is that the regulator acts decisively and without prejudice when firms act against their clients' interests. Evidence does suggest that asymmetry of treatment is not uncommon and we have seen several instances where small firms have been treated more harshly than larger firms undertaking the same inappropriate activity. We hope that the FCA's change in approach will ensure that a firm regardless of its size, or individuals regardless of their position will be treated equally should they commit the same offence. CFA UK has commented that when it comes to penalizing firms, fines are not enough especially in the more serious cases. Only by making an example of firms that do act against the interests of their clients can the FCA hope to improve the quality of suppliers. We would hope that the thematic work being done with respect to wealth managers provides a useful guide as to how the FCA will promote the quality not just the quantity of suppliers.

Insufficient emphasis on the demand-side of the market

The FCA's aim should be to enhance the quality of the market for financial services. This requires more effective interaction between demand and supply. Consumers need to be a more effective source of market discipline on firms and the FCA should aim to maintain a high quality of supply.

On the demand side, we would like to see the FCA help consumers by educating them with regard to how to identify the right types of products, services and firms that are appropriate to their needs. The FCA should devote more energy to ensure that consumers are becoming a more capable and effective source of market discipline on firms. CFA UK welcomes the FCA's recognition of the value of insights from behavioural economics. Equally important is the need for the FCA to support consumers in identifying the appropriate providers and products. The Money Advice Service is a useful starting point but more could be done.

Role of professional bodies

To deliver its outcomes, the FCA will rely on gathering intelligence much in the same way the FSA does by focusing on consumer and practitioner panels, and rely on whistleblowers. There is no mention of professional bodies. It is surprising that for a body that focuses on conduct there is little scope for professional bodies like the CFA UK to play a role in restoring trust and confidence. CFA UK's members abide by a Code of Ethics and Standards. The society's aims include the promotion of higher professional standards and market integrity. One area where the CFA UK would have been helpful is the recent publication about Asset Manager conflicts. The Code and Standards are very clear about how our members should ensure they are aware of their regulatory responsibilities and how to manage conflicts. To help our members further we will be publishing a position paper on conflicts of interest in the near future.

Principles of authorisation

We would also hope that when assessing entrants for authorisation the FCA does not apply asymmetry of treatment. We note the intention that prospective FCA-only regulated firms will not be authorised if their products and services pose a risk to customers. Risk in this context needs to be defined as investment risk (as opposed to savings or insurance) product contains risk.

On authorisation of individuals, we would hope that spent convictions, whether financial or otherwise, would be taken into consideration to the extent to which they cast doubt over the integrity of an individual. On the subject of accepting change of control, we believe that the FCA would have to have demonstrably well-founded concerns in order not to accept such a change of control.

We would also hope that when preventing new entrants to the financial sector the FCA does not apply asymmetry of treatment. For example, allowing incumbent firms that pose risks to consumers to remain while preventing firms that pose the same risk from being authorised. The FCA will need to ensure that it can demonstrate that its desire to improve the quality of suppliers is consistent in all of its activities.

Product control

It is a concern that there may be an excessive focus by the FCA on simplicity at the cost of choice. It is our view that the overwhelming majority of financial product is designed to meet a need. Therefore, the problem comes not in manufacture, but in distribution, when financial product is sold more widely than its suitability. The decision to ban unregulated collective investment schemes (UCIS) is a case in point and provides a contradiction to the FCA's consideration of product governance, which CFA UK considers to be the key issue.

The ability to ban financial products should be used rarely, if at all. Such a ban would be one way to address the manufacture of financial products that were unsuitable for any market, but should such a situation arise, there should be a wider question mark over the firm that was the originator of such a product. It would be far better that broader action were taken against firms whose management was of a poor enough quality that they could permit the launching of products without any market suitability. Where a product has a valid market, but there is the risk of mis-selling, we would like to see action not to ban the product but to issue clear guidelines on assessing suitability for that particular product.

Should a product be banned without a consultation, a 12 months ban is too long. Swift action should be taken to launch a consultation under such circumstances and a 6 month period seems a more reasonable maximum. We are pleased that the FCA has ruled out a product pre-approval scheme, however a product notification scheme, akin to the one governing the design of tax avoidance schemes, may have some validity to assist the FCA in effectively monitoring the market.

<u>Sales incentives</u>

Sales incentives might fall into one of these categories:

1) Appropriate sales incentives that encourage better productivity among staff.

2) Poorly designed schemes that are easily manipulated by staff.

3) Incentive schemes designed purely to place a firm's interests first.

The regulator should be concerned about those in the latter two categories. Identification of such should alert the regulator to culture issues at the firm and within senior management. Just as the FCA has recognised product governance as a key issue, so it should also recognise the importance of incentive governance. Every effort should be made to hold those responsible to account, rather than focus solely on the incentive scheme itself. As we have seen in one large financial organisation, the drive to place its interests ahead of its clients pervaded throughout its different businesses, affecting retail, wholesale and corporate clients. In such an organization incentive structures are only a symptom of the problem, governance at the top is the most significant challenge for the regulator.

<u>Miscellaneous</u>

It was with interest that we note that the FCA may be given responsibility for consumer credit regulation. We will be interested to learn the FCA's stance towards pay day loans in due course.

<u>Conclusion</u>

There is much in the "Journey to the FCA" that provides us with reasons to be optimistic. However, there is an equal amount that continues to maintain our concerns about the effectiveness of the new conduct regulator. The issue of having sufficient resources will be central to the FCA's effectiveness and we would hope that the FCA can give this further consideration given its broad mandate and long list of objectives. The FCA's success will be measured by how well it enhances market integrity, provides appropriate protection to consumers, its interaction with professional bodies and the focuses on the quality of the firms in the sector.

We trust that these comments are useful and would be pleased to meet with senior FCA officials to explain them or to develop them.

Yours,

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