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Dear Ms Vicary,

CP17/36: Reviewing the funding of the Financial Services Compensation Scheme (FSCS): feedback from CP16/42, final rules, and new proposals for consultation

The Investment Association ("IA") is the trade body that represents UK investment managers, whose 320 members collectively manage over £6.9 trillion on behalf of clients. The industry is a key part of the UK's financial ecosystem. It helps millions of individuals and households save for the long term, enabling them to have a more secure and prosperous retirement. This is a responsibility we take very seriously. Consequently we hope that the FCA will recognise that this response should not be seen as representing only a single entity but provides the views of a large number of organisations.

We strongly support the concept of a compensation scheme of last resort ("CSLR") and recognise the need to achieve an equilibrium between improved resilience of the funding and its fairness. Building consumer confidence in financial services is essential for the future success of our industry. Without trust in financial services our members cannot expect to retain or build upon their existing customer base. However, we think it important for the FCA to undertake a root cause analysis of failures borne by the FSCS to ensure that its funding does not become an excessive "cost of doing business". Compensation cannot, and should not be, a substitute for proper oversight and supervision and intermediaries' own insurance arrangements.

The IA welcomes the opportunity to comment further on this issue given that a number of our responses to CP 16/42 do not appear to have been considered. In particular, where rules have been made we would have expected more feedback in response to our concerns and explanations. We also feel the proposals do not appear to support the ongoing aim of HMT's Investment Management Strategy II of making the UK an attractive fund domicile. Furthermore, any proposed changes should not materially disadvantage successful business models already in the market. We wish to continue to work collaboratively with the FCA on the proposals and we would be happy to discuss any elements of our response.

Yours sincerely,

Ross MacLean
Regulatory & Compliance Specialist

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RESPONSES TO FCA CONSULTATION PAPER CP 17/36

EXECUTIVE SUMMARY

There are a number of areas where we have concerns regarding both proposals and "made rules".

Root cause analysis

The IA strongly supports the concept of a CSLR within financial services where consumers have suffered from the failure of a firm with which they have entrusted their money. However, we do not believe that the FCA has sufficiently examined the reasons why claims are made on the FSCS and the root cause issues. We believe there are three fundamental reasons why the FSCS is called upon:

Authorisation

In agreeing to authorise a firm the authorisation process has not sufficiently recognised the fragility of the firms: senior management resources (financial and non-financial); business model; or other market issues (such as occurred in the payday lending markets). Weaknesses in the authorisation process allow firms into the regulatory perimeter which simply do not have the resilience to exist long-term in the market. Thus, our first call is for the FCA to re-examine its authorisation processes in light of the continuing calls put upon the FSCS, and hence the industry, to learn the lessons visible to the industry.

Supervision

By firms knowing they will be screened against a set of rules, including acceptable investment strategies, by the FCA, the more inappropriate products ought to be screened out. We query if ongoing supervision of distribution business practices is robust enough to screen out inappropriate practices that continue to place a call on the FSCS when they are unable to meet their liabilities.

Deauthorisation

The FCA should conduct a root and branch review of its deauthorisation process and learn from the experience that continues to see previously authorised firms continue to cause issues when their businesses have ceased operations. Surety bonds, professional indemnity insurance, personal (and company director) guarantees, are clearly areas where further work is needed to bolster the financial resources available to investors when firms fail.

We wish to see a strong, vibrant and dynamic distribution sector, that is both robust and resilient. Ephemeral firms leaving customers, especially vulnerable retail customers, relying

on the FSCS is a markedly sub-optimal outcome as it weakens trust in the whole industry, not just in the distribution sector. The answer to this issue is not bolstering post-mortem contingencies but, rather, in ensuring the adequacy of firms allowed into the regulatory perimeter and, then, their ongoing supervision to ensure that calls on the FSCS are minimised.

We do not wish to see the FSCS levies treated as simply a "cost of doing business" as they could be a sign of weakness in the regulatory system. Anything beyond a minimum level (the results of changing circumstances affecting the past business of a well run, deauthorised firm that has left its affairs in good order) should be concerning to all. Therefore we look forward to seeing the "package of enhanced measures for the monitoring and supervision of the advice sector" committed to in the CP.

Cross Subsidisation

The concept of affinity is an imperfect one. We do not believe there is an automatic responsibility of product providers to underwrite the failure of all distributors for all types of business they conduct. This would stretch affinity simply too far. It does appear the funding proposals start from a position that stretches both Responsibilities of Providers and Distributors for the Fair Treatment of Customers ("RPPD") 1.9 and FSMA s.213(5). For instance, a manager dealing in only UK equities should not be held responsible for the failure of a distributor advising on highly speculative offshore products. Referring to specific instances: Keydata and ArchCru - the Lifemark product was a Luxembourg vehicle. The claims on the FSCS came from distribution of an overseas product. Behaviourally, intermediaries who sell offshore products should not be able to rely on onshore product providers to provide a type of post-mortem finance. We do not think that product providers that cannot or choose not to provide such products should be liable for any compensation coming from the failure of such business.

Similarly, our members who do work with intermediaries who are well capitalised, with extensive PII cover, and where practice and standards are substantially different from the majority of failed firms, also feel little affinity with those intermediaries selling offshore products. Thus, we believe the FCA should revisit its proposals which have been drawn too broadly and fail to reflect the clear differences in business model and approaches. Further work is required to find a new, more resilient, and better trusted way of financing the FSCS rather than using the proposed affinity basis.

Made rules relating to authorised funds and "look through"

The FCA has suggested that they are adding to investor protection by including "look through provisions" in relation to collective investment schemes. This does not recognise the fact that the FCA's own rules are designed to ensure that the likelihood of a claim against such a fund or manager is minimal (as we pointed out in our previous response and evidenced by the minimal number of claims against our members at FOS). In particular, the assets they manage are held by a third party which is also regulated and completely independent of the manager. If the aim is actually to create a greater pool of monies available to the FSCS, that fact should be stated explicitly, without suggesting that there are benefits in terms of greater protection for investors in authorised funds.

At the moment, the UK fund industry appears to receive no regulatory premium, or "dividend", for all the safeguards that exist around such funds. This is an important aspect

as the regulatory environment should be designed to encourage, support and reward positive behaviour and outcomes.

The adoption, as "made rules", of the proposals in Q.22 of CP 16/42 (whereby fees derived from the operation of CIS, or management of investments of a CIS, will now form part of annual eligible income) does not appear to be in reaction to identified risk of failure on the part of regulated funds, operators and advisers.

We are disappointed that these rules have been made without Cost Benefit Analysis in either CP 16/42 or 17/36, and would invite the FCA to promptly undertake one. Further, it is essential that the FCA commit to a schedule to undertake a post implementation review of any changes proposed (ideally no longer than two years from introduction).

The FCA's current proposals will increase the pool of available monies from those firms who previously considered themselves not to have any "annual eligible income". Whilst it could be argued that this increased pool would support the wider industry reputation (by providing reassurance to UK retail investors) it is equally true that it could be seen as suggesting to retail investors that additional protection is needed. In either case, the FCA should be mindful of increasing costs further on any part of the industry at a time when the investment management industry is considering its post-Brexit future and regulatory costs in other comparable European member states are lower.

In order to avoid significant sums being unnecessarily treated as "annual eligible income" our members look to the FCA to support achieving transparency on the status of the underlying participants.

For all the above reasons, we consider that the proposals the FCA has put forward are inadequately supported by evidence, cost benefit analysis or argument. They are an attempt to get others to pay the bill for business model or indeed regulatory failures when our members cannot effectively influence the business decisions made by firms that give rise to the claims. We therefore call on the FCA to undertake further work with the industry to ensure that all regulated firms can have confidence in the creation of a long term sustainable FSCS (as the repeated revisions to the FSCS funding basis are distracting for firms and fail to instil confidence in the FSCS's operations).

RESPONSE TO SPECIFIC QUESTIONS

1. **Do you have any views on our proposal to prevent personal investment firms (PIFs) from buying PII policies which exclude claims when the policyholder or a related party is insolvent?**

   We consider this to be a positive proposal.

2. **Do you have any views on the potential to require PIFs to hold additional capital in trust, for the purposes of contributing to any FSCS claims?**

   None, as per response to Q1 above.

3. **Do you have any views on requiring PIFs to obtain a surety bond?**

None, as per response to Q1 above.

4. **Do you have any comments on our proposals to merge the Life and Pensions Intermediation funding class with the Investment Intermediation funding class?**

The proposal does not take account of the distinct roles of product manufacturers and distributors. Investor losses stemming from mis-selling or poor advice are beyond the control of the product manufacturer yet under these proposals they would be liable for any claims arising from such failings in the distribution chain. Further, as per the concerns raised in our Executive Summary, until the "house has been put in order" we are not convinced by such a potential large increase in costs without either Cost Benefit Analysis or root cause analysis having been undertaken. We do not agree with the proposal that these funding classes should be merged.

PRESCRIBED RESPONSIBILITIES

5. **Do you agree with our proposal to move pure protection intermediation from the Life and Pensions Intermediation funding class to the General Insurance Distribution funding class?**

We have no comment on this proposal.

6. **Do you agree with our proposal to change the class thresholds for FCA product provider classes to represent 25% of the relevant intermediary claims funding class threshold? If not, what alternative would you suggest?**

Although we received a number of views from members on this proposal, of varying strength, we do not believe that the FCA has made its case, and would need confidence that the FCA's enhanced supervision package is effective, before considering whether or not we could agree. Further work would need to be undertaken to establish what the actual consequences would be of the change, especially for the costs falling on firms and in different circumstances particularly in cases where costly failures have occurred in unregulated products that our members do not produce.

Introducing an obligation for investment providers to contribute from the first pound towards FSCS funding relating to claims caused by intermediary defaults would be a breach of RPPD 1.9 and the principle of Financial Services and Markets Act 2000 s.213(5). The last funding model review in 2012/2013 included the following principles:

- compensation costs should ultimately be borne to the fullest extent reasonable by those with the closest business affinity to the defaulting firm, and in proportion to their affinity to that firm;
- cross-subsidies should be paid by firms with a close business affinity and shared commercial interest with the defaulting firm;

- levy caps should be set by reference to default risk and affordability; and any recoveries should be credited to those firms that bore the burden of a compensation levy who have the least business affinity to the defaulting firm.

These principles not only support fairness in a general sense; they are also fair in a very real, and commercial, sense and they support the regulatory system by targeting the burden of default at those most closely associated with the failure.

Any contributions have to reflect accurately the responsibilities of product providers and should not merely be based on a link to the products being distributed. While there is a relationship between product providers and distributors it is one based on commerce and the basis of the Retail Distribution Review (RDR) was to clarify the on-going boundaries of this relationship. There may be instances where close affinity exists in specific business models, firms or commercial relationships but it is not the case that mere affinity creates complete financial inter-relationship, nor does it demonstrate responsibility across the market. We understand the desire to balance the benefits of risk mutualisation to minimise the calls on the retail pool and protect consumers, with fairness of the funding model, but recognising the fundamental differences in business models and regulatory regimes between product providers and intermediaries is critical in drawing that balance.

It represents a direct contradiction to the RDR and the policy imperative to increase independent oversight across the investment supply chain, and is not supported by the product governance requirements of MIFID II which are designed to ensure that distributors have the information they need to identify target markets and appropriate clients.

We also note with interest Recommendation 3 of the Australian Government's current "Review of the financial system external dispute resolution and complaints framework" that such a compensation scheme "should be funded by financial firms engaged in the types of financial services covered by a CSLR" and "ensuring that all firms providing the types of financial services covered by the CSLR make and appropriate level of contribution". [1]

We consider that the proposals the FCA have put forward are inadequately supported by evidence or argument. They are an attempt to get others to pay the bill for intermediary failures when our members cannot effectively influence the circumstances that give rise to many of the claims.

Thus, it is our contention that the FCA engage further with the industry to find a new, more resilient, and better trusted way of financing the FSCS, rather than using the proposed affinity basis.

As we have previously commented, the IA agrees with the introduction of risk-based levies. We would encourage the FCA to assess risk, based on past events in different peer groups of contributors. It would be appropriate to distinguish between different business models and regulatory environments within the different funding groups and to adjust the levies within a funding group based on the actual risks. The proposals should not materially disadvantage successful business models already in the market.

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[1] https://static.treasury.gov.au/uploads/sites/1/2017/11/Supplementary-Final-Report-2.pdf

An alternative funding method to consider could be to require that those authorised firms who have been subject to disciplinary procedures (and specifically fines) should pay a small proportion (say 5%) of any fine to the FSCS, who could hold any monies in a ring-fenced account before contributing to the total of any compensation payable in a year. Similarly, fines on individuals who have been fined due to inappropriate selling practices could be directed to the FSCS in full. Clearly this would require changes to the policy and rules underlying the imposition of penalties under FSMA but this might be an alternative way to bolster the funding of the FSCS[2] and would not seem to require a change to FSMA.

7. **Do you have any comments on our proposal for how the retail pool will operate?**

   This proposal is predicated on the assumption that the proposal to change the class thresholds for FCA product provider classes to represent 25% of the intermediary claims funding class is enacted. We do not agree with that proposal.

8. **Do you agree that we should increase the FSCS compensation limit for investment provision, investment intermediation, home finance intermediation claims and debt management claims from £50,000 to £85,000?**

   We agree with the proposal to increase the FSCS compensation limit to £ 85,000.

9. **If you do not agree with the proposal above, do you have an alternative proposal?**

   No comment.

[2] A simple calculation of 5% of the fines paid 2013-2017 as stated on the FCA website suggests c£30 million per annum could have been provided to the FSCS during the period.