FINANCIAL CONDUCT AUTHORITY

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Dear Chief Executive

Our supervision strategy for Corporate Finance Firms

The FCA supervises firms with similar business models and regulatory permissions as part of a portfolio of firms. You are receiving this letter because we supervise your firm as part of the portfolio of corporate finance firms[1] (CFFs). This letter outlines the harms to consumers and markets we think are most likely to arise from the business models of CFFs. It also sets out our strategy to address these harms and our expectations of you.

The CFFs portfolio consists of around 500 firms. It includes firms that predominantly advise corporate clients seeking to raise funds or execute strategic transactions. It also includes firms that offer ancillary services such as corporate broking and investment research. CFFs typically raise funds from institutional investors and treat the corporate issuer as a client and investors as a corporate finance contact.

We expect you and your Board to discuss the contents of this letter, consider how the risks apply to your business and take action to manage them effectively. As Chief Executive, the Senior Managers and Certification Regime makes you responsible for ensuring the firm's compliance with our rules and principles for business.

The role of CFFs

CFFs play a critical role in the UK economy. They source capital for businesses, fuelling the creation of jobs and wider economic growth. In particular, they support small and medium sized enterprises in raising capital, price formation and maintaining secondary market liquidity. As such, CFFs are a vital part of the financial ecosystem and have an important role to play in maintaining the integrity, transparency and competitiveness of UK capital markets.

We also understand that there is a great deal of heterogeneity in the business models of CFFs. So, it is important that our supervisory approach is mindful of the different roles played by different types of firms and the potential harms different activities pose.

There are currently around 40 CFFs whose services include acting as FCA Sponsors, AIM

[1]CFFs derive most of their regulated revenues from corporate finance business. The business models of CFFs may overlap with other portfolios. If you believe your firm's business model doesn't match our description of the CFFs portfolio, please let us know.

Nominated Advisers, AQUIS Corporate Advisers or LSE Registered Market Makers. Some of these firms are market makers that supply liquidity to the Retail Service Provider (RSP) system and ultimately to retail investors. Many CFFs advise on M&A transactions of listed[2] companies. When they operate at their best, CFFs that provide these services are a robust first line of defence in upholding market integrity and improving consumer outcomes. However, as the underlying securities are listed there is an inherent risk of harm to markets and consumers from market abuse.

Many CFFs raise funds for unlisted companies. They reach a diverse investor base and offer access to a wide and varied pool of capital. When they act with integrity in undertaking these activities, CFFs provide a crucial service to the UK economy. They support innovation and entrepreneurship and facilitate the supply of a wider range of investment opportunities. However, as the underlying investments may be less liquid, there is a risk of exposing consumers to high-risk investments that do not meet their needs.

Part of our supervisory focus is to check firms' business models and their approach to the key risks of market abuse and selling unsuitable products to consumers. Earlier this year we issued a survey under s165 of FSMA to all CFFs (the CFFs Survey). We intend to update the CFFs Survey annually to inform our view of the portfolio key risks and our supervisory strategy.

Market and regulatory context

The sector has faced challenging market conditions since the Russian invasion of Ukraine. Lower IPO and M&A activity has impacted most CFFs and there has been cost rationalisation and consolidation in the sector in response to the downturn. Overall, the CFFs sector has been resilient during this period of lower transaction activity and market integrity has been upheld. We expect any CFFs that take on higher-risk business during a period of low activity to have commensurately strong controls.

The UK Listing Review and the Future Regulatory Framework Review marked the onset of wide-ranging reforms to improve the effectiveness of UK primary and secondary wholesale markets. These reforms propose significant changes to the UK regimes for listing, admission to trading and public offers to streamline the primary and secondary capital raising process for issuers. The FCA will make new rules to implement these new regimes when consultations conclude. The FCA also aims to make new rules in response to the Investment Research Review. CFFs are important stakeholders in these reforms.

There have been significant regulatory changes to prevent harm to consumers. Stronger financial promotion rules for high-risk investments have been in place since 1 December 2022. Firms will soon need to apply to the FCA at the s21 authorisation gateway for permission to approve financial promotions for the purposes of s21 of FSMA. The Consumer Duty came into force on 31 July 2023 requiring firms in scope to put consumers' needs first.

We expect firms to keep abreast of regulatory changes. CFFs have a vital role to play as market participants in maintaining clean, liquid, and orderly UK markets and acting with integrity. We will hold firms that do not to account.

Drivers of harm

The activities of different CFFs will pose different risks of harm. Our overall supervisory approach

[2]In this letter we use 'listed' to refer to companies whose securities are publicly traded or the population of securities that are publicly traded (rather than in the legal sense to denote securities admitted to the FCA Official List).

will cover the drivers of harm outlined below, but each of these will apply to some CFFs more than to others. It is your responsibility to consider the drivers of harm that are applicable to your firm.

Unsuitable products to consumers

A significant number of CFFs provide a service, in the course of carrying on a regulated activity, to retail and elective professional clients. Some CFFs also facilitate significant fundraising from individual investors, who CFFs would ordinarily treat as corporate finance contacts when the relevant conditions are met.

CFFs may advise a small business or a local authority that does not meet the criteria in COBS 3.5 to be treated as a professional client. Retail clients may lose important protections and compensation rights when treated as professional, so firms can cause harm if they miscategorise them. Similarly, CFFs can cause harm to retail investors by inappropriately treating them as corporate finance contacts when the relevant conditions are not met. This can happen when a firm behaves in a way that might reasonably be expected to lead an investor to believe that they are being treated as a client, and when a firm does not clearly indicate to the investor that it is not acting for the investor and will not be responsible for providing protections afforded to clients. A firm's relationship with an investor may not meet the corporate finance contact conditions or might evolve into a client relationship. In these circumstances, the firm will be responsible for providing client protections to the investor.

Under the Financial Promotion Order (FPO)[3], communications to sophisticated investors and high net worth individuals are exempt from the financial promotion restriction in s21 of FSMA if the investors satisfy the exemptions' criteria and the conditions for the exemptions to apply are otherwise satisfied. Many CFFs avail of these FPO exemptions[4] when they communicate financial promotions. Retail investors who are inappropriately classified as sophisticated investors or high net worth individuals may lose significant protections from high-risk products and suffer losses they may not be able to afford. Similar harm to investors can also occur when firms do not properly consider the client category of a prospective recipient of a financial promotion for the purposes of complying with the financial promotion rules, particularly the rules applying to communications with retail clients. A corporate finance contact is not a recipient or likely recipient of a service in the course of a firm carrying on a regulated activity and is therefore not a client of the firm in this context. However, a corporate finance contact as a recipient or likely recipient of a financial promotion is a client of the firm that communicates or approves the promotion, for the purposes of the financial promotion rules[5]. We have previously seen harm to consumers crystallise via activities with CFFs from fraudulent or unsuitable high-risk investments.

Many CFFs undertake unregulated activities as part of their business model. We have seen examples of firms that keep FCA permissions they have not used and do not need. Often these firms are connected to groups, entities or individuals undertaking unregulated business. In these circumstances, there is a risk that FCA authorisation can appear to lend credibility to unregulated activities and mislead consumers into thinking they are protected when they may not be. Of particular concern are retail customer type permissions that are not used for regulated activity or are not limited to corporate finance business.

Market abuse

[3] The Financial Services and Markets Act 2000 (Financial Promotion) Order 2005.
[4] HM Treasury consultation on reforming the FPO exemptions.
[5] We refer to COBS 3.2.1R(3), COBS 3.2.2G in the FCA Handbook. In this context, the requirements on general notifications (COBS 3.3) and record keeping (COBS 3.8) are unlikely to apply (COBS 3.1.3R).

Market abuse undermines the integrity of the UK financial system, eroding confidence and lowering participation to everyone's detriment. The risks of market abuse are heightened in CFFs that act for listed corporate issuers and therefore routinely have inside information, and also trade in listed securities for the firm and for their clients. We have seen examples of CFFs with poor UK Market Abuse Regulation (UK MAR) systems and controls. These include ineffective information barriers, inadequate processes for the identification of inside information, poor wall crossing controls and incomplete or inaccurate insider lists. We have also seen failings when undertaking market soundings, including not obtaining the consent of recipients before disclosing inside information and not communicating to recipients that they are no longer inside.

Poor management of conflicts of interest and lack of transparency can erode market integrity and lead to poor client and consumer outcomes. We have seen situations where firms do not identify and record all conflicts by considering both the conflicts that arise in the inherent business model, and conflicts in relation to clients and transactions. We have seen examples of incomplete and not sufficiently detailed conflicts registers. We have also seen examples where conflicts arising from staff directorships and staff or firm shareholdings in corporate clients are not properly discussed at committee meetings.

Personal Account Dealing (PAD) activity carries a high inherent risk of insider dealing and conflicts of interest. The rules governing PAD are set out in COBS 11.7 and COBS 11.7A. The FCA has previously published concerns about PAD. We continue to see examples of poor PAD practices where firms do not adhere to their PAD procedures, staff trade without proper compliance approval and securities are not properly added to restricted lists.

Financial crime

CFFs may deal with overseas clients and investors or advise on cross-border transactions. Overseas activity and complex corporate structures, often involving offshore vehicles and trusts, can make it difficult to identify the ultimate source or recipient of funds raised, or counterparty to a transaction. CFFs that do not undertake robust financial crime due diligence in the course of their business can cause significant harm to markets and consumers. Further, in light of the evolving UK and international sanctions regime since the Russian invasion of Ukraine, CFFs that do not regularly test and update their financial crime systems and controls can be more susceptible to a potential sanctions breach from their activity.

Financial resilience

Many CFFs perform a purely advisory role. Whilst their failure would impact clients who may be in the course of executing a transaction or may be relying on specialist advice from the firm, these firms pose a lower risk of harm in failure to markets and consumers. However, a number of CFFs hold material client assets, are significant liquidity providers or advise a large number of AIM or AQUIS listed clients. Their disorderly failure would have a material impact on markets and consumers and erode confidence in the sector as a whole.

Our supervisory priorities

1. Client categorisation

We expect firms to comply with the client categorisation requirements in COBS 3 in relation to clients they provide a service to in the course of carrying on a regulated activity. In particular, COBS 3.5 sets out the criteria to be met for a client to be treated as a per se professional or elective professional client. We will undertake targeted reviews of firms' client categorisation practices to ensure their processes are effective and follow procedures for the quantitative and qualitative tests required under COBS 3.5. We will ask firms to provide evidence of compliance with COBS 3.5.3R, which sets out the requirements for a firm to treat a client as elective professional. Of particular concern is where COBS 3.5.3R(3) is not followed, as in such cases we do not have evidence that the client wishes to be treated as professional and understands the protections and rights they may lose. We will challenge firms where we are not satisfied that retail clients are appropriately categorised or where we are not satisfied that they have the right customer type permissions for their business model.

In the next CFFs Survey we will ask firms for data about their investors and types of products marketed to them. We will use this data to undertake targeted reviews of firms' investor categorisation practices. Given the risk of investor detriment, firms can expect us to take robust action, including the application of business restrictions, if we see abuse of the corporate finance contacts regime or financial promotion exemptions.

2. The Consumer Duty

The Consumer Duty (the Duty) generally applies to firms that conduct retail market business, where they can determine or materially influence retail customer outcomes in a retail distribution chain, even if firms don't have a client relationship with the retail customer. The Duty is unlikely to apply to a number of wholesale activities[6].

However, the Duty has an intentionally far-reaching and wide perimeter, and it is your firm's responsibility to carefully consider its application to the firm's activities and ensure it is correctly applied. In particular, as CFFs typically face both clients and corporate finance contacts, firms must assess the extent of the Duty's application to both sides of their activity.

Where CFFs provide services to retail clients in the course of carrying on regulated activities, their activities may be in scope of the Duty. Further, the Duty applies to the process used by firms for client categorisation. CFFs encouraging clients to seek professional client classification simply to circumvent the protections afforded to retail clients would breach the Duty. If a client has been incorrectly classified, or the firm becomes aware that a client has been previously incorrectly classified, the firm should reclassify the client and restore the correct level of protection.

On the investor side, the Duty may also apply to firms' activities with a retail investor treated as a corporate finance contact. The Duty applies when firms communicate or approve financial promotions relating to retail market business that are likely to be received by a retail customer[7]. As already noted, a person to whom a financial promotion is, or is likely to be communicated, is a client of the firm that approves or communicates it, and that includes corporate finance contacts for the purposes of the financial promotion rules.

Firms that treat retail investors as corporate finance contacts when the relevant conditions are not met, simply to avoid affording them client protections, would breach the Duty. Similarly, firms that incorrectly classify retail investors, who do not meet the criteria, as sophisticated or high net worth individuals in relation to the FPO exemptions, or to avoid COBS 4 rules applying to communications with retail clients, would breach the Duty.

Assessing the extent of the Duty's application to CFFs' activity will sometimes require the exercise of judgement. In making this assessment, we expect firms to consider the entire distribution chain

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[6] We refer to the definitions of retail market business, non-retail financial instrument and retail customer in the FCA Handbook.
[7] Under PRIN 3.2.6R(2).

and whether they can determine or materially influence outcomes for retail customers. Where distribution chains are long and complicated, we expect firms to do what is reasonable when assessing retail customer outcomes.

The CFFs Survey collected data about firms' approach to the Duty. Our initial focus will be on firms with retail clients. If your firm has retail clients and has not considered the Duty or considers that it is not impacted by the Duty, we will ask you to explain your rationale and approach. We may ask to see relevant analysis about how the Duty applies and the firm's approach to complying with the rules. Where firms fail to comply with the Duty, we will also hold senior management to account.

3. Dealing with problem firms

We expect CFFs to use their regulatory permissions to advance a legitimate business purpose, and to construct and maintain their permission profile in a way that accurately reflects this. We continue to see firms that appear to hold permissions for no clear business purpose or in order to favourably influence public perceptions of their unregulated business.

Incorrect or outdated permissions on the Financial Services Register can mislead consumers about the level of protection offered by a firm or give credibility to a firm's unregulated activities. The FCA has reminded firms of their ongoing obligation to review their permissions and only maintain those they need. Further, you must notify the FCA if your business model has changed since you last shared it with us.

We will contact firms that do not appear to be using their regulatory permissions to understand why they need them and will invite firms to vary or cancel their permissions where appropriate. Where firms do not do so voluntarily, we will use our powers to remove firms' unused permissions and prevent firms from misleading consumers.

We expect CFFs to have the corporate finance business limitation to their designated investment business or retail customer type permissions if this reflects the firm's business model. We will be inviting firms that we think should but do not have this limitation to vary their permissions accordingly.

To protect markets and consumers from harm, the FCA needs to be able to communicate reliably with the firms it supervises. We also expect CFFs to be open and transparent with us. We continue to see firms that we cannot reach, or that do not respond properly or in a timely way to our communications. We expect your firm's contact details on Connect to provide a current and effectively monitored email address, so the firm receives and actions our communications. If you do not respond to our repeated requests for information, we will consider enforcement action to cancel your permissions.

The FCA is a data-led regulator. We expect firms to provide timely, complete and accurate responses to our requests for information and on RegData. This requires attention to the currency, units, period and description of the data being requested and submitted. Where we identify gaps or data errors in firms' regulatory responses and returns, we will ask firms to explain their submissions to us. We will challenge firms that do not submit regulatory returns on RegData.

4. Market abuse

Firms must ensure market abuse controls are tailored to their individual business models. We expect CFFs to have robust prevention cultures, and systems and controls to discharge their obligations under UK MAR. We also expect CFFs to properly identify, record and manage conflicts of interest. These requirements are set out in Principle 8 and the rules in SYSC 10. CFFs must consider conflicts arising both from their inherent business model and from new clients and new transactions taken on.

The FCA has been conducting reviews of firms' systems and controls to comply with certain aspects of UK MAR, their PAD policies and conflicts of interest obligations. Typically, we focus on their design and operational effectiveness in selected transactions. In these reviews, we seek to understand the firm's role in the transactions and the firm's systems, controls, policies and procedures both generally and in relation to the transactions. We are particularly interested in understanding the firm's approach to the creation and maintenance of insider lists, the maintenance of access logs, wall crossings, and the carrying out of market soundings. Depending on our observations, we may extend the scope of our reviews to the firm's compliance and governance arrangements. We expect compliance functions to be actively challenging and monitoring firms' activities and to systematically escalate and inform senior management of issues in the area of market abuse, conflicts of interest and PAD.

We will continue to conduct these reviews and seek to cover a range of relevant business models. On completion of our assessment, we provide feedback to firms. Where we identify material failings we will consider the need for criminal, civil or supervisory sanctions to provide effective deterrents. We will hold senior management to account where firms fail to address risks and remedy failings and to embed a culture of compliance.

As well as continuing these reviews, we aim to undertake targeted cross-firm PAD reviews in the next supervisory cycle.

Next Steps

You must notify the FCA immediately if you consider that your firm does not meet our requirements. By the end of November 2023, we expect you to have discussed with your directors and your Board the contents of this letter and to have agreed appropriate actions and next steps.

If you have any queries about this letter, please contact our dedicated Supervision Hub on 0300 500 0597. This is the primary contact for your firm's day-to-day interactions with the FCA. Further details of how we can be reached are available on our website at https://www.fca.org.uk/contact.

We recognise there may be occasions when your firm faces urgent issues of strategic importance and in such circumstances, please contact Man-Ching Fung-Buschmann, CFFs portfolio lead, at Man-Ching.Fung-Buschmann@fca.org.uk.

Yours sincerely

Jon Relleen
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