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By email: cp17-37@fca.org.uk

9 February 2018

Dear Mr Measor

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

The City of London Law Society ("**CLLS**") represents approximately 17,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Regulatory Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

We welcome the opportunity of responding to this consultation and discussion. In summary, we believe that there is a significant risk that the effect of these proposals would be to encourage the proliferation of a multiplicity of codes, all seeking regulatory recognition, thus presenting significant challenges and increased litigation risk for firms. It does not seem to us that the proposals will deliver greater clarity around the regulator's expectations, and we are of the view that they may instead foster over-reliance on the fact of recognition, at the expense of a more holistic consideration of the risks that unregulated business may present for each firm.

We also consider that the regulator's current powers are sufficient to enable it to tackle serious misconduct by regulated firms, and that the case for the extension of the scope of Principle 5 to all unregulated activities (beyond activities that are ancillary to regulated activities), giving the regulator very broad discretion to take enforcement action, has not been made out.

Recognition of Industry Codes

We do not consider that the regulatory recognition of industry codes is the most appropriate means by which the regulator should communicate its view of what constitutes proper standards of market conduct with regard to unregulated markets or activities.

The legislature has conferred on the FCA responsibility and extensive powers for making general rules and guidance, including in respect of unregulated activities, in order to advance its objectives. We recognise that the use of the FCA's powers to give guidance may create a perception on the part of clients and counterparties that the FCA will take additional steps to supervise conduct in unregulated markets. However, the same perception may be created through the FCA's recognition of industry codes. We believe that the provision of regulatory guidance, where required, would better empower counterparties and clients to engage with what they consider to be poor conduct, and would be more likely to deliver clarity to firms and individuals as to the appropriate standard of conduct.

In particular, it seems to us very likely that the fact of recognition would fundamentally change the voluntary nature of those codes that the FCA did choose to recognise.

We acknowledge that the proposals seek to address or avoid this risk by noting that whilst following a code would tend to show compliance with the FCA's rules (the Principles for Businesses), a firm may comply in other ways; yet this would also be the case were the FCA to provide guidance. Nonetheless, whereas the provision of statutory guidance would be subject to a range of checks and balances, the FCA does not propose to consult formally on either code content - although the regulator would expect ongoing engagement in the recognition process between the code authors and its policy teams - or in respect of a recognition decision - although the FCA would envisage gathering some views.

We accept that code authors may well have consulted some stakeholders during the development of a code. However, if the recognition process is to deliver a degree of regulatory protection for those who comply with it, then one can readily see that stakeholders who are the recipients of services or products may have been less motivated to engage with the development of what they perceived to be an initiative of service or product providers, but would wish to be heard on the question of whether that code delivers the standards to which the industry would be held by the regulator. The proposed recognition process does not appear to us to deliver full transparency in respect of either process or outcome.

We acknowledge that industry codes can provide value for market users in providing a benchmark of how they are behaving by comparison with their peers, and may be used by industry bodies as a marketing tool to claim that members always act in a way that is 'best practice'. It does not appear to us appropriate that something that is set forth as best practice should be regarded as the proper measure of whether the Principles have been breached. Where 'best practice' codes have been adhered to, however, it seems to us that a breach of Principles should not, or not readily, be found.

We are particularly concerned that there is a significant risk that the effect of these proposals would be to foster the proliferation of a multiplicity of codes all seeking regulatory recognition, as indeed the Consultation Paper recognises. We agree with the FCA that identifying which codes to follow and ignore in unregulated markets may present significant

challenges for some firms. The creation of numerous industry codes will also potentially create increased litigation risk for firms, although this is not touched on in the Consultation Paper.

It also seems to us that there are potential risks for the FCA as competition regulator in being prepared to endorse, through recognition, the output of certain industry representative bodies, and not those of others. The Consultation Paper recognises the possibility that several competing codes might be developed covering the same market or activity but with conflicting provisions. The solution proposed is that the FCA would be unlikely to provide recognition "in order to avoid defining a market standard". Whilst this may deal with some potential competition issues, it fails to fulfil the stated objective of delivering greater clarity around the regulator's expectations, in precisely the circumstances where market participants would most benefit from a regulatory view (see further below in respect of the discussion regarding the extension of Principle 5 of the Principles for Businesses).

It also seems to us that the recognition process and the proposed time limit on recognition are insufficiently dynamic in terms of regulatory engagement to ensure that such codes continue to deliver practical up to date guidance as technologies, market structures, products and services continue to develop and evolve. There is also some risk that some might place over-reliance on the fact of recognition, potentially at the expense of vigilance and critical thinking aligned to business activities and risk profile on the part of the individual firm in question. Potential gaps in the coverage of recognised codes seem to us to create a particular area of risk in this regard.

Extension of the application of Principle for Businesses 5 (A firm must observe proper standards of market conduct) ("Principle 5") to unregulated as well as regulated activities

As paragraph 6.4 of the Consultation Paper acknowledges, Principle 5 already applies to unregulated "ancillary activities", defined as activities carried on in connection with a regulated activity, or held out as being for the purposes of a regulated activity.

The Consultation Paper describes the case under discussion as the extension of Principle 5 more widely to unregulated markets, and/or to the unregulated activities of authorised firms. These are two quite different concepts and the distinction is an important one.

The legislature has chosen the markets and activities which are to be the subject of FCA regulation, and in our view the legislature should decide whether this is to be extended. This is different from the FCA considering whether the behaviour of a regulated firm, considered as a whole, is such that the FCA's confidence in that firm's ability to comply with the requirements set out in the Principles with regard to its integrity, care, skill and diligence, and potentially its ability to organise itself to manage risk, has been shaken. Focusing on the approach also avoids any perception that the FCA is interfering in the ability of firms to act as participants in these unregulated (by the FCA) sectors, which by definition are not required to subject themselves to FCA supervision at all – in a way which might potentially have the effect of distorting competition in those markets.

Section 1B(1) of FSMA requires the FCA, in discharging its general functions, to act so far as possible in a way which is compatible with its strategic objective of ensuring that the "relevant markets" function well. However, those markets are more narrowly defined in section 1F as being financial markets, markets for regulated financial services and the markets for services involving the carrying on of regulated activities by exempt persons.

We recognise that section 137A of FSMA empowers the FCA to make general rules applying to authorised persons with respect to the carrying on by them of unregulated activities where

it appears to be necessary or expedient to do so for the purpose of advancing one or more of its operational objectives.

Given the ambit of the FCA's powers, we therefore assume that the proposal under discussion is the latter, and that the reference in paragraph 6.6 to unregulated markets is intended to be shorthand for the unregulated activities of authorised firms.

The FCA's intention as stated in the Consultation Paper is to focus only on the financial markets activities of authorised firms, and only to take action in the case of serious firm-level misconduct in authorised firms, to address actual or potential harm. Nonetheless, the proposed extension of the Principle would represent a very significant extension of the FCA's enforcement remit, giving it broad and largely unfettered discretion to take enforcement action, without the normal counterbalance of an assumption of supervisory support and responsibility on the part of the regulator, nor any provision of guidance to firms to assist in dealing with uncertainty.

We acknowledge that extending Principle 5 as proposed would make it explicit that the regulator may take action in relation to unregulated activities. However, this is already explicit in PRIN 3.2.1AR in respect of unregulated activities that are ancillary to regulated activities, and otherwise evident from the action already taken by the regulator under its current powers in the FX and LiBOR cases.

Under the SMCR, individuals in relevant authorised persons are already required to comply with proper standards of market conduct in relation to unregulated activities, and this obligation is to be extended to the wider population of authorised firms. We also note that prior to the introduction of the SMCR, the FSA took action against Mr Kyprios for inappropriate behaviour in an unregulated market. Given that a firm can only act through its individuals, it seems to us that the concomitant obligation on the firm in respect of its unregulated activities more appropriately resides in the requirement for the firm to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems and is adequately covered by Principle 3, as relied on in the LiBOR/FX cases).

Group activities

We note that the provision which currently extends the application of Principles 3 (in a prudential context), 4 and 11 to all activities of authorised firms, PRIN 3.2.3 (2) R also takes into account any activity of other members of a group of which the firm is a member.

The discussion section does not indicate whether the intention is to apply PRIN 3.2.3 (2) in respect of the extension of Principle 5 to unregulated activities, and our working assumption is that this is not the FCA's intention. The application of Principle 5 to the activities of the group which includes an authorised person would be an unwarranted extension of the FCA's remit.

Many large global corporate conglomerates whose core business is outside the financial markets (Retailers, Mining, Energy, Pharmaceutical) have within their group an authorised firm, which may have little or no influence over the direction and conduct of the firm's core businesses. We would not see a case for making authorised firms responsible for the conduct of their group members, although we recognise the obligation under Principle 11 of an authorised firm to inform the regulator of issues within the group that could impact on its own reputation, or a group outsourcing or financing arrangement that might affect its financial soundness.

Clarity

The discussion section suggests that extending Principle 5 more widely to unregulated activities would provide clarity to firms on the FCA's general expectations (6.10). However, the FCA does not propose to prescribe what the proper standard of market conduct is, nor to supervise firms' unregulated activities; it is therefore not immediately evident that firms will in fact benefit from significantly greater clarity in respect of the regulator's expectations.

Whilst the proposed recognition of an industry code would signal the FCA's acceptance that a code tended to articulate a proper standard of market conduct, and that compliance with the spirit and the letter of the code would tend to indicate that a proper standard of market conduct was being adhered to such that it would not usually take action against a firm for behaviour that was compliant, the FCA would also nonetheless expect firms to consider codes of conduct that had not been recognised, and might use such codes evidentially in enforcement action as it does presently. We also note that as the FCA does not propose to maintain or publish a list of codes that it has chosen not to recognise, firms may face significant and potentially unjustified cost in needing to engage with such codes.

In conclusion, it does not appear to us that the case for extending the scope of Principle 5 to unregulated activities (beyond ancillary activities) has been made out.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours sincerely

Karen Anderson
Chair, CLLS Regulatory Law Committee

THE CITY OF LONDON LAW SOCIETY
REGULATORY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

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