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Dear CEOs: Market Abuse, Conflicts of Interest and ESG at the Forefront of the FCA's Supervisory Strategy

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The FCA has recently published a new 'dear CEO' letter setting out its updated supervisory strategy and priorities, including key risks and areas for improvement for regulated firms.[1] While the letter is addressed to firms active in the alternative investments sector, it provides valuable insight into the FCA's general priorities. These include, in particular, market abuse and conflicts of interest (which have been the subject of recent FCA enforcement activity), as well as ESG-related disclosures (reinforcing the FCA's stated aim to combat 'greenwashing', which we have previously examined).[2]

Market Abuse

The FCA's letter identifies market abuse controls as an area in need of improvement. To comply with their obligations under the UK Market Abuse Regulation ("**UK MAR**"), firms should ensure not only that they have the necessary controls in place, but also that those controls have been appropriately tailored to their individual businesses. Where a firm fails to do so, the FCA "*will consider the need for criminal, civil or supervisory sanctions to provide effective deterrents*". Sanctions for breaching UK MAR can include public censure, prohibitions on firms or individuals carrying out regulated activities, and/or unlimited fines; and sanctions under the criminal regimes for insider dealing and market manipulation can include custodial sentences of up to 10 years and unlimited fines.

The FCA's focus on combatting market abuse is also clear from recent enforcement action. For example, on 5 August 2022, shortly before the publication of the 'dear CEO' letter, the FCA announced that it had imposed a fine of £80,000 on the former chairman (the "**Chairman**") of ConvaTec Group Plc ("**ConvaTec**") for unlawfully disclosing inside information (in breach of Articles 10 and 14(c) of UK MAR). Specifically, the FCA found that the Chairman had negligently disclosed inside information to senior individuals at two of ConvaTec's shareholders before that information had been properly announced to the market.[3] Notably, the fine was imposed notwithstanding the fact that (among other things) the Chairman did not stand to benefit financially from the disclosures, and the disclosures were not shown to have had an adverse effect on the market, or a significant impact on ConvaTec's share price.[4] In fact, the FCA accepted the Chairman's explanation that he believed himself to be acting in the best interests of the company when he made the disclosures.[5]

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1 https://www.fca.org.uk/publication/correspondence/portfolio-letter-alternatives-2022.pdf
2 Please see Milbank's previous client alert, '*ESG Disclosures: UK Regulation and Litigation Risks*' here.
3 https://www.fca.org.uk/publication/final-notices/sir-christopher-gent-2022.pdf
4 *Ibid.* at paragraph 6.17.
5 *Ibid.* at paragraph 6.25.

In addition to civil enforcement action, pursuing criminal prosecutions in relation to market abuse offences also continues to be a key part of the FCA's deterrence strategy. In an update published in June 2022, the FCA noted that: "*Where it is right to do so we take criminal action. Already this year we have been in court for a trial in which the jury was unable to reach a verdict. We have another trial involving two defendants scheduled to start in October 2022 and a further three cases in which prosecution decisions will be made relating to 10 individuals before the end of the year.*"[6]

In the same update, the FCA also emphasised its continued use of civil enforcement action in connection with market abuse: "*We also make use of our civil enforcement powers, which has a different standard of proof. More than 10 subjects are currently awaiting decisions on their cases, following our investigations for market abuse or manipulation.*"

Conflicts of Interest

The FCA's letter also highlights poor management of conflicts of interest, in breach of Principle 8 of the FCA's Principles for Businesses, as a significant concern which "*can encourage market manipulation or improper fund performance reporting, in turn producing poor consumer outcomes and loss of market integrity.*"[7] In particular, the FCA refers to cases of firms bypassing their own conflicts of interest processes in order to make sales or increase assets under management as examples of conflicts which have caused detriment to investors. Accordingly, "*Firm Boards should carefully review their procedures to ensure conflicts are avoided, managed, or disclosed in a way that minimises harm to investors and markets.*"

Internal firm conflicts, and conflicts arising as a result of dominant shareholders making material decisions independent of the firms' governance structures, are also identified as situations that can "*lead to conflicts and increase the risk of poor outcomes for investors*". The FCA therefore calls on firms to "*consider the impact of their shareholder structure and the potential implications this has on the effective governance of their organisation*".

The FCA highlights two recent cases in which it levied fines against a hedge fund management firm and an asset management firm for failing adequately to manage conflicts of interest.[8] The fines in question were substantial, amounting to £40,806,700 and £9,103,523, respectively. In one of these cases, the FCA also levied a fine against a former director of the firm, whose conduct was found to have breached regulatory rules in relation to conflicts of interest.[9]

In the Decision Notice issued to the hedge fund management firm, the FCA noted, in particular, the group's "*reactive*" approach to addressing conflicts of interest.[10] Further, certain disclosures were deemed to be "*entirely insufficient and, at times, misleading*";[11] and, while the group had a conflicts of interest policy in place, it lacked the necessary controls required to prevent conflicts arising, and to identify and address those conflicts which did arise.[12]

Several of the failures identified in relation to the asset management firm related to the failure to implement effectively the firm's conflicts of interest framework: for example, the Board had only limited discussion of conflicts of interest (despite its responsibilities in this regard), and although the firm had appointed a conflicts of interest committee and officer, the committee did not meet regularly and it was found that the

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6 https://www.fca.org.uk/news/news-stories/market-abuse-manipulation-update. See also https://www.fca.org.uk/news/statements/jury-discharged-insider-dealing-trial-without-verdict.

7 Under Principle 8 of the FCA's Principles for Businesses, firms "*must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client*". Further details of this duty are contained in the FCA Handbook at SYSC 10, which requires firms to (among other things) "*maintain and operate effective organisational and administrative arrangements*" in respect of conflicts of interests, including maintaining a satisfactory conflicts of interest policy.

8 https://www.fca.org.uk/publication/final-notices/gam-international-management-limited-2022.pdf https://www.fca.org.uk/publication/decision-notices/bluecrest-capital-management-uk-llp.pdf

9 https://www.fca.org.uk/publication/final-notices/timothy-haywood-2022.pdf

10 https://www.fca.org.uk/publication/decision-notices/bluecrest-capital-management-uk-llp.pdf at paragraph 2.14.

11 *Ibid.* at paragraphs 2.12 and 5.6.

12 *Ibid.* at paragraphs 2.9-2.11.

firm did not adequately promote the role of the conflicts of interest officer to employees.[13] The FCA also identified failures to conduct a documented process to consider the relevant conflicts of interest, and failures to disclose the conflicts to customers, as indicators that the firm had not managed those conflicts fairly.[14]

ESG and Other Key Areas

Significantly, the FCA reiterates its focus on environmental, social and governance ("**ESG**") matters, and the importance of *"investors* [having] *confidence in the products they are being offered*."[15] Accordingly, firms offering ESG-labelled products (and whose investment strategies are benchmarked against ESG themes) must ensure that their descriptions of such products (and any relevant documentation) are clear and not misleading, and that they reflect their stated claims.

The FCA makes clear that ESG will remain a priority for its Asset Management department, stating that firms offering ESG-focused products "*should expect to be subject to review to ensure marketing materials accurately describe their product, with funds offering clear and consistent disclosure*".[16] The FCA also reminds assets managers of the climate-related disclosure rules which it introduced in December 2021, which require qualitative and quantitative information to be provided (at both entity and product level).[17]

The FCA's letter is not confined to market abuse, conflicts of interest and ESG disclosures, but also addresses a number of other topics at the forefront of the FCA's agenda. These include managing consumer risk (in anticipation of the new Consumer Duty which is set to come into force on a phased basis, starting in July 2023) and the role of a firm's corporate culture in promoting compliance.[18] As to the latter, the FCA states that "[e]*vidence of staff being unable to speak up is an area of concern*"; and (echoing a theme raised in relation to conflicts of interest, as noted above) "*we are interested to understand how healthy cultures are embedded in firms where founders or other senior individuals occupy a dominant role.*"

Comment

One of the overriding themes of the FCA's letter is that a firm must consider its specific circumstances, including its corporate structure, the nature of its client base, and the level of risk inherent in the market in which it operates, when assessing the adequacy of its measures for managing risks of market abuse, conflicts of interest and other issues. The primary responsibility for this generally lies with a firm's Board or Executive Committee, which should regularly assess the risks applicable to the firm and the adequacy of its compliance framework in mitigating those risks. In practice, it is also important that firms keep clear and comprehensive records to ensure that compliance can be demonstrated.

In addition, the letter emphasises the FCA's continued focus on ensuring effective deterrence, including in the form of financial penalties against both firms and individuals. This is reinforced by the recent enforcement decisions referred to above (among others). Overall, firms would be well-advised to review their systems and controls thoroughly, ensure that demonstrably robust compliance frameworks have been instituted and kept up to date, and potentially consult expert external advisers for additional scrutiny and recommendations.

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13 https://www.fca.org.uk/publication/final-notices/gam-international-management-limited-2022.pdf at paragraph 2.8.

14 *Ibid.* at paragraph 2.15.

15 For a more detailed examination of the FCA's approach, and the associated risks for firms, please see Milbank's previous client alert, '*ESG Disclosures: UK Regulation and Litigation Risks*' here.

16 In June 2022, the FCA published a Feedback Statement (FS22/4) along with Primary Market Bulletin 41, setting out its policy response and potential future actions in relation to the integration of wider ESG matters in UK capital markets, as part of a review of the effectiveness of primary markets. See https://www.fca.org.uk/publication/feedback/fs22-4.pdf and https://www.fca.org.uk/publications/newsletters/primary-market-bulletin-41.

17 https://www.fca.org.uk/publication/policy/ps21-24.pdf

18 https://www.fca.org.uk/publications/policy-statements/ps22-9-new-consumer-duty

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