FCA FINANCIAL CONDUCT AUTHORITY

12 Endeavour Square
London
E20 1JN

Tel: +44 (0)20 7066 1000
Fax: +44 (0)20 7066 1099
www.fca.org.uk

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Dear Chief Executive,

The FCA takes a strategic view towards supervising firms that operate similar business models. You are receiving this letter because we are setting out our new strategy for supervising wholesale brokers, which is how we define your firm at the FCA.

This letter details our view of the most important risks arising from wholesale brokers, what we think drives those risks, and the FCA's supervisory focus for the next two years. 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.

Wholesale broker firms

Wholesale brokers play a valuable role in financial markets, sourcing pools of liquidity for clients and helping buyers and sellers to match, negotiate and transact. The level of discretion they have in arranging transactions means that when they operate at their best, they improve customer outcomes and can provide safeguards for upholding market integrity.

While brokers generally don't aim to take market risk in their core activities, volatile markets tend to be profitable for them because price movements incentivise many of their clients to trade more, and spreads can be wider. However, since we set out our last supervisory strategy for the sector in 2019, periods of sustained volatility have also resulted in heightened financial, credit and operational risks in many parts of the markets where wholesale brokers are active. In volatile environments the nature of risk taken can transform between different risk types, sometimes rapidly, with operational or counterparty risks sometimes leading to market risk for even those firms who do not typically take it. Over the recent period we have also particularly focussed on the subset of clearing brokers that face heightened liquidity risks as a result of having to post collateral to clearing houses at short notice to cover their positions before having been paid by their own customers. During these periods, we found that some firms' liquidity risk management and stress testing was not fit for the current market environment.

We see gradual improvement in inherent conduct risks facing the sector but with many false starts and laggards. While we have seen some improvements in governance and compliance controls at larger firms, our work suggests wholesale broking firms generally continue to be behind others in stopping poor conduct and improving culture. This view is supported, for example, by our recent work to assess brokers' controls against financial crime, which found weaknesses in many firms, notably that few firms turn away new or existing clients regardless of the level of money laundering risk they pose. Similarly, our exercise on broker hiring practices also raised concerns around the quality of brokers' fit and proper assessments and firms' surprising willingness to hire individuals who had not demonstrated good standards of conduct at their previous firms. Holistically we find that, too often, firms' control functions are not properly resourced or empowered to effectively challenge the business, resulting in compliance controls that are inadequate for effective risk management. This can lead us to question whether boards have appropriate oversight of these areas, or indeed if they understand the value that they bring. We see these functions, when properly empowered, as having the potential to make better business decisions day-to-day, as well as reducing exposure to risk in extreme events, whether legal risks, reputational, or prudential. We expect firms to continue to focus on improving standards in this regard, and we think that managing these risks will pay off for firms in anything but the shortest of terms.

What our wholesale broking strategy will focus on

2022 brought a stark change to the macroeconomic environment across global markets, with the reintroduction of inflation, changed priorities and approaches of central banks, and heightened expectations of recession. The structure of financial markets has changed a lot since the last major downturn, with a changed role for banks, the growth of non-bank finance, and often a reduction in liquidity in times of stress.

It is plausible that the next two years sees heightened systemic risk and episodes of market stress, as we have seen in energy, metals and government bond markets in 2022. Boards should consider this context and reflect how their business models may expose them to risk, and how this can be mitigated.

We will remain agile to new issues over the period and will update our approach as events dictate. Nevertheless, we have reflected on this changing context and drawn from recent supervisory work to identify the following four key areas of focus for wholesale broking firms:

1. Financial resilience

Where firms have adequate capital and liquidity, they are far less likely to cause market disruption if they fail, and in the event that they do, a prudent approach will mean that the risk of clients suffering losses is greatly reduced. As we have seen this risk both crystalise and nearly crystalise during recent market shocks in the commodity markets, we are particularly concerned by weaknesses in clearing brokers' liquidity risk management. We know that this will not be relevant to all recipients of this letter equally, but boards should consider the circumstances in which it might be.

We have observed that firms fail either to develop their own competence on liquidity risk management sufficiently, or to recruit expertise externally to help address this issue. As a result, firms continue to underestimate their exposure to intraday liquidity risks arising from their own business as well as from key clients and counterparties. By consequence, the amount of liquidity they hold may not be sufficient to survive instantaneous shocks as well as periods of extended market volatility and stress. This could result in disorderly wind downs and raise the risk of contagion and potential systemic defaults along with widespread market disruption. Even in milder wind down scenarios, clients can end up losing money if firms have poor client asset controls.

To improve financial resilience, firms should review the level of liquidity that they hold under the new Investment Firm Prudential Regime (IFPR) and ensure that their assessment is commensurate with the risks they face. We will be carrying out targeted work in this space, and where we identify material weaknesses or firms underestimating their liquidity needs, we will take action, which may include business restrictions and Board effectiveness reviews.

Firms should also look beyond recent historical precedent when modelling stresses, noting that the past 12 months have produced a series of events that were previously considered implausible based on historic modelling. While we generally expect to see more prudence in this environment we accept there are limits to capital and liquidity that can be held against stresses, which mean a careful balance must be struck. However, this is less true on operational matters, where mitigants can be built in through planning, with fewer trade-offs. Firms should seek to model stress events in more extreme, or reverse stress scenarios, and consider what they might need, or need to provide in these circumstances, and test what can be done to reduce vulnerability in those events. Finally, on both financial and operational matters, firms should remember that many market stresses will include a systemic event rather than an idiosyncratic one, and they should consider a feedback loop with other participants as a matter of course.

2. Remuneration structures

Our 2019 'Dear CEO' letter[1] highlighted issues around weak incentive and reward structures that we believe remain. In particular, we continue to see brokers receiving lower salaries with large cash bonuses based on the value and volume of trades they conclude for clients, which may lead them to focus on achieving short-term financial targets at the expense of client interests. Such structures can incentivise brokers to push trades through by whatever means possible and reduce firms' ability to penalise brokers for misconduct if it is identified after bonuses have been paid.

In January 2022, we introduced the MIFIDPRU Remuneration Code (SYSC19G) under IFPR, which supports prudential soundness and risk management, by promoting accountability, discouraging poor conduct, and prioritising positive outcomes by helping to instil a healthy firm culture. As part of the regime, fixed and variable remuneration must be appropriately balanced, with fixed salaries making up a sufficiently high proportion of total remuneration. Individual performance must take account of both financial and non-financial criteria of which a substantial part of the non-financial criteria may include metrics on conduct. Firms will need to ensure that their remuneration structures match the risks associated with their business model and higher risk firms (i.e., those categorised as non-SNI)[2] must identify 'Material Risk Takers' (MRTs) whose professional activities have a material impact on the risk profile of the firm or the assets it manages. These individuals are subject to more stringent remuneration requirements where appropriate, such as deferral, malus and clawback, which help to mitigate against short-termism and excessive risk taking.

We expect wholesale broker Boards and CEOs to ensure that their remuneration structures comply with the new IFPR remuneration requirements. In 2023, we will focus on ensuring that firms are appropriately applying deferrals, malus and clawback when remunerating relevant staff. This will include looking at how practices have changed since we gathered data on industry wide practices in 2019, and what boards have done to assess the risks. Where firms have failed to evidence that they have taken appropriate steps to implement the required IFPR remuneration requirements, we will consider using our range of regulatory tools, including routinely imposing additional capital requirements to account for the increased risk that weak incentives can drive.

3. Governance and culture

Boards play an important role in instilling a healthy and purposeful culture at firms, which is essential for embedding an effective approach to risk and incentivisation. Wholesale broker firms that are governed by Boards with a suitable mix of skills and experience for the firm to draw on

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[1] https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-wholesale-market-broking-firms.pdf

[2] Small and non-interconnected (SNI) firms are MIFIDPRU investment firms that satisfy all the conditions set out in [MIFIDPRU 1.2.1R]

and that provide effective challenge to the management are more likely to make better decisions, manage risks and to succeed in this competitive sector.

Similarly, a firm's Senior Management Functions should possess adequate and appropriate skillsets and be receptive to challenge to ensure decisions are made with a comprehensive consideration of risks involved. Frequently in our engagement with firms, and particularly with firms that have been the subject of whistleblowing or enforcement investigations, we have found that poor decision making and failures in oversight played a key role in exacerbating the extent of any underlying issues or preventing them from being resolved earlier. Therefore, firms should continue to embrace the Senior Managers and Certification Regime (SMCR) to promote good decision making and individual accountability, and with an understanding that the nature of their business means that relatively junior employees (in terms of traditional hierarchy) can expose broking firms to significant risk of harm to the firm, their clients and the market more broadly.

In line with the requirements arising from the certification regime, firms can also help themselves to avoid conduct risk by properly taking into account regulatory references when hiring new certified staff and considering appropriate risk mitigations with any individuals where adverse information comes to light in the hiring process. This an area where our work has identified weaknesses across a number of broking firms and that we continue to focus on in the regulatory cycle. There will be little sympathy for firms that suffer the consequences of market integrity offences through hiring individuals who have been disciplined elsewhere, and not accepting the cost of additional control or oversight. Boards should ensure they understand and are comfortable with the risk appetite that executives have been working to here.

Additionally, we recommend that Boards pay particular attention to the issues around financial resilience and remuneration mentioned above. Where our work in these areas uncovers weaknesses, we will scrutinise the decision making and Board effectiveness of these firms.

4. Control functions

We expect firms to comply with all relevant FCA rules, to consider relevant guidance, and to have adequately resourced risk management and control functions, with influence at board level. To achieve effective compliance, firms should stay abreast of the risks posed by their business models, design clear policies and processes around those risks and promote a culture where adherence to their rules is actively encouraged.

Financial crime and market abuse mitigation are areas where we commonly find brokers have weak systems and controls, and firms should continue to develop safeguards to mitigate these risks. Our recent work highlighted widespread deficiencies in wholesale brokers' client onboarding processes to control financial crime and money laundering and we look to carry out further work in this field in the year ahead.

Additionally, where we see weak surveillance controls in the sector, it raises the risk of market abuse. For further guidance, firms should consider Market Watch 62[3] where we shared our concerns about Personal Account Dealing (PAD) and Market Watch 69[4] where we discuss firms' arrangements for market abuse surveillance, drawing on our observations from engaging with small and medium-sized firms.

[3] FCA Market Watch 62: https://www.fca.org.uk/publication/newsletters/market-watch-62.pdf
[4] FCA Market Watch 69: https://www.fca.org.uk/publications/newsletters/market-watch-69

Next steps

As CEO, the Senior Managers and Certification Regime makes you responsible for ensuring that relevant staff at your firm understand our rules and principles for businesses and for ensuring that your firm complies with them. If you are not meeting those rules and standards, you must notify the FCA immediately, setting out what you are doing to remedy any breaches.

By end-February 2023, we expect all CEOs to have discussed this letter with their fellow directors and/or Board and to have agreed actions and/or next steps.

If you have any questions about this letter, please contact your named supervisor if your firm has one. If you do not have a named supervisor, please contact us 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. However, we recognise there may be occasions when your firm faces urgent issues of strategic importance. In such circumstances, please contact either your named supervisor or the Manager of the Wholesale Brokers Flexible Supervision Team, Ulla Suomio at Ulla.Suomio@fca.org.uk.

The FCA looks forward to working with the sector to continue to improve standards and market outcomes for you and your customers.

Yours faithfully,

Simon Walls - Director, Wholesale Sell-Side