

18 April 2019

Dear CEO

I am writing to explain our view of the key harms that brokerage firms operating in wholesale financial markets pose to their clients and markets. This letter also sets out our strategy to mitigate the drivers of those harms. You should consider and discuss this letter with your management board, and how the highlighted points apply to your business.

**Wholesale market broking firms**

When brokers perform their function well they play an important role in wholesale markets by sourcing liquidity and discovering prices, and bringing together buyers and sellers in financial instruments. However, this business model places broker discretion at its centre. As a result, it poses a high risk of harm to market functioning if brokers do not operate within an appropriate culture and control environment. They need to have an appropriate understanding of their obligation to act in their clients' best interests and to support fair and orderly markets. In our view, brokers in wholesale markets have made less progress than other sectors in embedding a culture of good conduct, and so action to raise standards across the sector has become urgent.

The markets in which wholesale brokers operate have been subject to major regulatory reform, through MIFID 2 and MAR, which has substantially raised the expectations placed on market participants and infrastructure. However, we find that, unlike other types of firms in these markets, brokers have not kept pace with, and have under-invested in, the requirements of this new legislative and regulatory environment. Although there has been some recent progress in the levels and quality of firms' compliance resource, and the sophistication of firms' systems and controls, supervisory intervention has more often driven these improvements than firms' own initiative. In general, we continue to see a complacent attitude and resultant failure to meet expectations across all the areas of regulation we have recently examined.

Our supervision strategy includes a programme of work to address these points and other drivers of harm to clients and markets. Our strategy covers the period to March 2021. We will write to you again after March 2021 to give our updated view of the key risks firms in this sector pose and our updated supervisory strategy.

## **Our view of the key drivers of harm**

We see four key drivers of harm in this sector, which we will focus on over the next two years:

- Compensation arrangements which incentivise poor conduct by linking broker remuneration directly - and potentially exclusively - to the commission they earn (the so-called 'eat what you kill' remuneration model). This can allow little or no scope to recognise non-financial indicators of performance in a fair and objective manner.
- Governance arrangements which do not give Boards and senior managers the tools they need to properly oversee their staff and business, and act accordingly. These governance arrangements also fail to embed clear accountability for conduct standards.
- Workflows which do not recognise that a broker may be performing different regulated activities or acting in different capacities from time to time. As a result, they do not ensure the necessary arrangements are put in place to identify and address conflicts of interest, or to ensure compliance with relevant regulatory obligations.
- A culture and mindset which underestimates the risk of brokers committing or facilitating market abuse and financial crime through their role as market intermediaries, combined with poor monitoring and controls.

## **What our supervision will focus on**

We will prioritise our supervisory work in the following areas:

**Compensation and incentives:** We see poor and outdated remuneration models as a root cause of misconduct risk in this sector. In particular the common remuneration model, which involves frequent, formulaic cash payments to individual brokers based on the revenue they generate allows little or no room for firms to adjust compensation for non-financial performance measures, or to assess those measures in a fair and objective way. In addition, these models do not encourage staff to take a long-term view of their performance.

We are currently reviewing market practices through a survey of around 50 firms in the sector. Preliminary findings show a worrying lack of awareness of obligations around the awarding of remuneration and, in some cases, material non-compliance. We will publish our findings later this year and will thereafter take a tough stance with all firms in pursuit of the changes we now see as both necessary and urgent.

**Governance and culture:** Individual brokers in this market are often their firm's principal revenue earners and relationship holders with their clients, and so have significant negotiating power. It is therefore important that firms have strong governance frameworks that allow their culture and values to drive decision-making across the business, including its approach to dealing with all kinds of misconduct. It is also critical that firms are headed by effective boards, with a suitable mix of skills and experience, to conduct appropriate oversight of the firms' risks, strategy, policies and controls.

The Senior Managers and Certification Regime (SM&CR) takes effect in December 2019 for this sector, and will form a key part of our strategy for driving change. It will provide greater clarity on roles and responsibilities of senior management and drive a greater sense of responsibility down through organisations via the certification regime. It will also implement new regulatory reference rules, which will enable firms' assessments of fitness and propriety to encompass the

full relevant picture of an individual's past conduct. During 2019, we will work with firms to ensure they implement the regime in an effective way that makes clear the key lines of accountability. We will also expect firms to demonstrate that they are headed by effective boards operating under appropriate mandates.

As well as more formal regulatory tools, we will also continue to pursue a broad range of supervisory approaches to drive improvement in this sector, such as CEO round tables and the [FCA's 5 conduct questions](#) programme. Such approaches facilitate the sharing of ideas and best practice and aim to encourage firms to consider the business benefits of a good conduct culture.

**Capacity and conflicts of interest:** Firms in this sector often conduct a range of investment services and activities, including broking, trading and operating trading venues. In our view, the sector is generally weak in identifying the particular capacity it is acting in for a given transaction. These weaknesses create a risk of substantial harm, as the arrangements to manage conflicts of interest and fulfil client-facing responsibilities effectively will often be different in each case. We expect firms to implement the necessary systems and controls to allow firms to identify, and apply the appropriate safeguards to, the particular service they are providing at a given time.

More specifically, we remain concerned that brokers are still inappropriately charging commission to liquidity providers from whom they source liquidity, a practice we have described as payment for order flow (PFOF). The cause of these practices may include failure to identify the firm's capacity, misunderstanding of our expectations around PFOF in some market segments, or creating structures or workflows, such as cross-border arrangements, which are designed to circumvent our rules and expectations. Through our ongoing supervisory work and market engagement, we will continue to assess whether firms have implemented the systems and controls necessary to appropriately characterise the service they provide. We will also be checking that firms are applying the necessary systems and controls to enable them to meet both the form and substance of their conflict of interest obligations.

We will soon publish a supervisory statement that addresses inconsistencies in the application of our rules on this issue. Thereafter, we expect firms to be fully compliant in this area and will consider appropriate interventions where we see individual cases of continuing non-compliance.

**Market abuse and financial crime controls:** We find firms are generally complacent about their responsibilities to monitor for and mitigate market abuse and financial crime risk. This includes both a lack of understanding of these responsibilities and underinvestment in systems and controls, including surveillance systems and training.

The wholesale broking business model poses an inherently high risk of market abuse. Brokers acting for market participants can be used to place trades or agree deals that amount to market abuse. Brokers can also be used to facilitate financial crimes like money laundering, if they fail to question or investigate suspicious activity when they are confronted by it. We will be looking for improved surveillance arrangements (including communication monitoring), and increased resource allocated to this task. Senior management should also be engaged in identifying market abuse and financial crime risks.

Brokers regularly hold significant non-public information about unexecuted client orders and trading intent and sometimes inside information on companies with publicly quoted securities.

If this information is not properly managed and controlled it can easily be abused and undermine confidence in markets. We have recently examined personal account dealing (PAD) at a number of broking firms, and we commonly found poorly designed policies that do not meet FCA requirements, and concerning low levels of PAD trades being reported. We will be publishing findings of this work later in the year, and following up with individual firms where shortcomings have been identified.

## **Technology**

Our previous work has also identified the importance of [technology](#) to this sector, but found serious deficiencies in resilience and readiness to combat cyber-crime. Brokers in wholesale financial markets are relied upon by their clients for the services they provide, and also hold important non-public information. If firms fail to prioritise investment in IT this can cause serious harm to the firm, their clients and the market. We will continue to encourage firms to properly test their IT controls and pursue necessary improvements in all parts of their businesses.

## **EU withdrawal**

We expect the senior managers of firms to take responsibility for ensuring that its plan will allow the firm to act in the best interest of clients, and in line with applicable regulatory requirements, in all possible Brexit scenarios. Firms should keep us closely informed of those plans, including their communications with clients

## **Next steps**

You should consider the issues in this letter and how they may be relevant for your business, and take steps to mitigate any issues that apply. We will be exploring the issues in this letter in our engagement with large and small brokerage firms throughout this year and next, and implementing our strategy to bring about changes. We will support our supervisory work with wider engagement and communication strategies to allow us to make clear our expectations of firms, proactively identify harms arising and ensure appropriate mitigation is put in place.

If you have any questions please contact your named supervisor if your firm has one. If you do not have a named supervisor, please contact the firm contact centre on 0300 500 0597. There are further details of how best to [contact us](#) on our website.

However, we know there may be times when your firm faces urgent issues of strategic importance. In such significant circumstance, please contact me on 020 7066 61270, or at [Simon.Walls@fca.org.uk](mailto:Simon.Walls@fca.org.uk) or the Wholesale Brokers team manager, Baljit Bhamra, on 020 7066 2250 or at [Baljit.Bhamra@fca.org.uk](mailto:Baljit.Bhamra@fca.org.uk).

Yours sincerely

**Simon Walls**  
**Head of Wholesale Markets Department, FCA**