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WHITE PAPER

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A Multifaceted Maze: The FCA's Role and Powers in Distressed Situations

The last five years have seen a substantial increase in the number and variety of regulated firms operating in the United Kingdom, with the development in particular of financial services provided by new technology firms, asset managers, challenger banks, payment providers and e-money issuers. At the same time, an increasing number of UK Financial Conduct Authority ("FCA") regulated firms have entered into insolvency proceedings. The FCA has stated that whilst the minimisation of regulated firm failure is a key priority for the FCA, it recognises that it cannot completely prevent firm failure, especially in light of COVID-19. Accordingly, in December 2020, the FCA published the Consultation Paper, in collaboration with the recognised professional bodies that licence and regulate insolvency practitioners ("IPs"), which aims to minimise disorderly failures of FCA-regulated firms.

Against this backdrop, FCA-regulated firms, their boards of directors, IPs and key stakeholders, such as banks, lenders and custodians, need to be aware of regulated firms' obligations to the FCA in an insolvency scenario and consider how they deal with the regulator.

INTRODUCTION

Under the Financial Services and Markets Act 2000 ("FSMA"), the UK Financial Conduct Authority ("FCA") has specific statutory rights and powers in relation to the insolvency of FCA-regulated firms.[1] However, insolvency may also trigger the FCA to invoke its general regulatory powers, to ensure that regulated firms comply with the broad range of regulatory obligations and conditions for authorisation.

In an insolvency scenario, the FCA may exercise a broad range of powers under FSMA in order to meet its operational objectives, particularly consumer protection. Guidance provided in the FCA Handbook highlights the importance that the FCA places on the safeguarding of consumers' assets when considering its involvement in insolvency proceedings.

In the event of financial distress, regulated firms and their key stakeholders, including lenders, need to carefully consider the FCA's potential multifaceted approach in an insolvency scenario in order to anticipate in advance how the powers of the FCA could be exercised in the event of insolvency proceedings. Strategic planning and early engagement with the FCA is beneficial for all stakeholders, particularly in light of the impact of COVID-19. In December 2020, the FCA published Guidance Consultation 20/5 ("Consultation Paper"). The Consultation Paper contains guidance as to the issues IPs should consider when advising regulated companies in financial distress and during any subsequent insolvency proceeding. Whilst the guidance remains subject to consultation, it provides useful guidance for IPs with the objective of minimising disorderly failures that cause serious harm to consumers.

OVERVIEW OF THE FCA'S INSOLVENCY POWERS

Regulated firms have a duty to inform the FCA immediately on the occurrence of a number of insolvency events, such as:

- The presentation of a petition for the winding up of the firm;[2]
- Any proposal to enter into an arrangement with one or more of the firm's creditors, most commonly by way of a company voluntary arrangement ("CVA") or scheme of arrangement;[3] and
- The appointment of an administrator, trustee in bankruptcy or receiver to the firm.[4] The FCA's prior consent is required for director led administrator appointments,[5] otherwise the administrators' appointment is nullified and a Court application is required to validate it retrospectively.[6] However, prior FCA consent is not required in the context of qualifying floating chargeholder (QFCH) led appointments.[7]

The Corporate Insolvency and Governance Act 2020 ("CIGA"), which came into force on 25 June 2020, has introduced a number of new procedures for companies in financial difficulty—some temporary as a result of the COVID-19 pandemic, while others create permanent additions to the UK's restructuring toolbox, namely the new standalone moratorium and restructuring plan processes (the latter being based on the existing scheme of arrangement procedure). However, the new CIGA provisions have limited application to certain types of regulated firms and build in various FCA protections and safeguards. The key proposals relevant to FCA-regulated firms are two-fold:

1. The provisions relating to the (i) new company moratorium procedure, (ii) suspension of termination rights in supplier contracts and (iii) temporary suspension of director liability for wrongful trading are not available to certain types of regulated firms, including banks, investment firms, insurers, and payments and e-money institutions; and

2. Where an FCA-regulated firm is able to use the new company moratorium or opts instead for the new restructuring plan procedure, the FCA is entitled to the same information and challenge rights as the company's creditors (in much the same way as it is in an administration process). The FCA (i) must also consent to the new moratorium process prior to implementation and (ii) has the right to appear at the two Court hearings when the new restructuring plan is considered and approved.

As any insolvency proceedings progress, the FCA has recourse to much the same rights as a company's creditors. For example, where a person has presented a winding up petition against an FCA-regulated firm or appointed representative, the FCA is:

- Entitled to be heard at the hearing of the petition and subsequent statutory hearings;[8]

- Required to be sent any notice or other document to be sent to any creditor of the company;[9] and

- Entitled to attend and participate at creditors' meetings.[10]

The FCA also has the power to:

- Participate in proceedings related to CVAs (and individual voluntary arrangements in the context of individuals) and certain administration applications under the Insolvency Act 1986[11]; and

- Petition the court for the compulsory winding up of regulated firms and unregulated firms that are carrying on regulated activities without authorisation. However, it should be noted that such measures are rare in practice, and the FCA will consider whether other powers under FSMA would be better placed to achieve the same or more advantageous results.

GUIDANCE ON THE USE OF THE FCA'S POWERS

The FCA Handbook provides guidance as to when the FCA will use its general powers under FSMA. The FCA's primary concern is achieving its objectives, including its operational objectives of protecting consumers, enhancing the integrity of the UK financial system and promoting effective competition.

In its pursuit of the above, the FCA will consider factors including:

- The extent of claims by consumers;

- The extent to which consumer assets are held by the regulated firm;

- Whether the regulated firm's creditors include shareholders, directors or other people involved in the management or ownership of the firm; and

- The complexity or specialisation of the regulated firm.[12]

THE CONSULTATION PAPER—FCA GUIDANCE FOR IPS

Given the increased number of FCA regulated firms entering into insolvency proceeding, in December 2020, the FCA published the Consultation Paper. The Consultation Paper sets out draft guidance for IPs when working with distressed and insolvent FCA regulated companies with the objective of helping to achieve "a better outcome for consumers and market participants following a failure of a regulated firm".

The guidance set out in the Consultation Paper emphasises the importance of earlier engagement with the FCA in relation to any distressed situation. Additionally, the FCA has stated that it expects regular updates from IPs for pre-agreed periods in respect of a number of factors including: client communications, client contacts, progress in reconciling and distributing client money, and possible sale of clients books.[13] In particular, the FCA has highlighted the need for a clear and detailed client communication strategy that considers practical issues such as language of communication and the need to share drafts of the communication with the FCA prior to the communications being sent to clients. The guidance, whilst still subject to consultation, provides a useful checklist for any IP when undertaking an initial assessment of an FCA-regulated firm.

Beyond administration and other insolvency processes, the Consultation Paper discusses the use of schemes of arrangement, CVAs and the new restructuring plan. As discussed above, the legislation provides the FCA rights of representation at court and creditor meetings. However, the FCA continues to emphasise that it also expects to be notified of plans in good time and that it should receive regular reporting on the progress of such procedures.

IMPACT OF COVID-19 ON REGULATED FIRMS

As part of its COVID-19 response, the FCA also has issued wide-ranging guidance to firms to support customers who are themselves struggling financially, for example, by offering payment deferrals. Clearly, complying with this guidance has a financial impact on regulated firms themselves. However, "this does not affect [the FCA's] expectation that consumers should be offered appropriate support in accordance with [FCA] rules and guidance where necessary".[14]

It is certainly possible to imagine a scenario where a regulated firm is forced to enter an insolvency process as a result of complying with the FCA's guidance-based (rather than rules-based) COVID-19 response, and may seek to challenge or diverge from the FCA's approach. In the meantime, the FCA has simply advised as follows: "Where firms, including those

subject to insolvency procedures, are concerned about the impact of providing payment deferrals or other forbearance in accordance with this guidance, they should contact us at the earliest opportunity."[15]

WIDER FCA INVOLVEMENT—PRACTICAL CONSIDERATIONS

In the Consultation Paper, the FCA emphasises the significance of the Insolvency Code of Ethics, when an IP considers whether they have or can acquire the requisite knowledge of FCA-regulated firms. From the outset of an authorised firm entering insolvency proceedings, IPs need to ensure they have the knowledge to determine which FCA rules apply to that firm. This will help to identify potential areas of focus for the FCA. For example, a firm that holds client money can expect the FCA to request full client money reconciliations at the outset and on a periodic (even daily) basis.

Where the FCA is looking at a potentially-distressed fund manager, it will focus on any redemptions from (and the continuity liquidity of) relevant funds under management. In some cases, the FCA may conclude that the safest course of action is to suspend any dealings in the relevant funds for a period of time. This will also influence which FCA departments and teams will likely be involved: Resolution will be involved in all cases, but teams such as CASS (client money and assets), the General Counsel's division (the FCA's internal legal department) and specialists covering Retail Funds, Consumer Credit and Wholesale Markets may also need to be involved. This can mean firms and IPs have a large number of FCA stakeholders to engage with, each of which can have different priorities.

In the context of an administration, where the administrators propose to continue operating the regulated business (for example, with a view to a sale after an accelerated marketing process), they should bear in mind that the FCA can use its general powers to require the firm to cease carrying on some or all of its regulated activities, including when the FCA identifies significant risk to customers or clients. In the context of an e-money issuer, this could lead to all customer accounts and transactions being frozen. This won't just cause headaches for customers, it will be value destructive for the underlying business and could potentially frustrate the purpose of the administration by either putting potential bidders off entirely or prompting them to lower their offers, meaning lower likely returns to creditors and a potential wind-down of the business instead.

As a priority during the appointment process, IPs should be pushing the board of directors/management team to identify any issues or "red flags" previously raised by the FCA prior to the insolvency filing, so that any such concerns or queries can be prioritised and addressed as soon as possible post-appointment.

It is also important to note that the FCA is likely to take an equally keen interest in any unregulated business carried on by the firm, even business that occurs outside the United Kingdom. This is to ensure that the impact of any unregulated or overseas business (which might be continuing during the UK insolvency process) is clearly understood. The FCA will pay particular attention to ensuring (to the extent possible) that there is no potential for UK customers to be disadvantaged in any way and will expect to be kept informed on customer updates and responses to customer complaints (made via the business website and social media platforms).

IMPACT ON THIRD PARTIES

The insolvency of a regulated firm has the potential to impact connected persons who must also consider their duties owed to the FCA. This will be a primary concern for other regulated firms that perform services for or on behalf of the company entering insolvency, such as banks, custodians, administrators and brokers. For example, in the context of an e-money issuer, the bank operating the underlying customer accounts may be obliged to freeze all operations as a result of the firm's insolvency.

In these circumstances, the connected firms must consider their own obligations to the FCA. They must be prepared to provide the FCA with necessary information and comply with any orders made in relation to the insolvency proceedings. Often the reactions of connected firms will be outside the control of the insolvent firm and its IPs. However, insofar as possible and appropriate, the firm in the insolvency proceeding should assist connected persons in achieving compliance (e.g., through timely notification of the insolvency). Whilst this adds another feature to the multifaceted FCA insolvency maze, a joined-up approach can navigate to a swift and successful outcome.

KEY TAKEAWAYS

When considering whether to intervene in an insolvency proceeding, the FCA will assess the extent to which its involvement would achieve its operational objectives of protecting consumers, enhancing the integrity of the UK financial system and promoting effective competition. Early engagement with the FCA is critical in order to preserve value and ensure the most favourable outcome for the benefit of all stakeholders.

The FCA will use its broad supervisory powers to look into the firm (and potentially its wider group) as a whole, considering both its regulated and unregulated business. This regulatory involvement can be far more wide-ranging and intrusive than firms (and their IPs) might expect.

The insolvency of an FCA-regulated firm will also affect those connected to it, such as banks, administrators, custodians and brokers, each of which will need to comply with its own procedures and regulatory duties, and whose reactions may be informed by, but ultimately outside the control of, the insolvent firm and its IPs.

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ENDNOTES

1 "FCA regulated firms" are firms that are authorised by the FCA to provide certain financial services which qualify as "regulated activities". There are many types of FCA regulated firms including broker dealers, consumer credit firms, fund managers, payment institutions and financial advisers.

2 FCA Handbook SUP 15.3.21(3)

3 FCA Handbook SUP 15.3.21(4)

4 FCA Handbook SUP 15.3.21(5); SUP 15.3.21(6)

5 Section 362A FSMA

6 *Gregory and others v ARG (Mansfield) Ltd [2020] EWHC 1133 (Ch)*

7 *Id*

8 Section 371 (2)

9 Section 371(3) FSMA

10 Section 371(4) FSMA

11 Sections 356, 357 and 362(4) FSMA

12 FCA Handbook EG 13.13.3

13 A full list of expected update categories can be found at paragraph 41 GC20/5

14 FCA Feedback Statement FS 20/9, 1 July 2020, paragraph 2.44 - https://www.fca.org.uk/publication/feedback/fs20-9.pdf

15 As above, FS 20/9, paragraph 2.46