7 July 2021

FIA EPTA response to UK Government (BEIS) consultation on "Restoring trust in audit and corporate governance."

Introduction:
The FIA European Principal Traders Association (FIA EPTA) appreciates the opportunity to provide feedback to the UK Government (BEIS) consultation on "Restoring trust in audit and corporate governance" (the Consultation).

FIA EPTA represents 30 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs. Included in those 30 firms are 21 FCA-regulated firms.

FIA EPTA members are independent market makers and providers of liquidity and risk transfer for exchanges and end-investors in the UK and elsewhere in Europe. Market making and liquidity provision (also referred to as principal trading or dealing on own account) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent Principal Trading Firms. These firms are [predominantly] privately owned, and trade using their own funds for their own risk, while being subject to regulation by the UK Finance Conduct Authority (FCA).

FIA EPTA members are supportive of measures to enhance transparency, corporate governance, and good market conduct and are generally supportive of many provisions in the Consultation. However, we note below the areas where we have concerns and believe further work and public consultation would be needed in order for the UK to develop an appropriate, proportionate regime that supports good corporate governance, the reputation of the UK as a good place to do business, and the competitiveness of the UK economy.

<u>Question 1:</u> Should large private companies be included within the definition of a Public Interest Entity (PIE)?
While FIA EPTA members agree that some private companies may have a sufficient impact on the UK market and public such that it would be appropriate to include them as PIEs, FIA EPTA does not support an approach that categorizes all private companies above certain size thresholds as PIEs.

The size thresholds proposed in the Consultation align to size thresholds for the application of the Wates Principles on the one hand and the thresholds proposed for mandatory climate-related financial disclosures for certain entities on the other and so as such are intended to be consistent with other

obligations on large private companies. However, while the proposed criteria offer clarity and consistency with other requirements, FIA EPTA members are of the view that purely size-based criteria using financial accounting metrics are not a well-calibrated measure of public interest.

While we understand the need for bright-line, clearly applied tests to determine whether a company is a PIE or not, FIA EPTA does not believe that size alone is an appropriate measure of public interest. The criteria as currently proposed risk being overly broad in light of the concerns noted in the Consultation. Including all companies above a certain size risks capturing private companies that employ relatively few people, have few UK clients, do not have external investors and are not funded from external sources, and so are not likely to give rise to the various issues the Consultation and the Kingman, Brydon and Competition and Markets Authority reviews underlying the Consultation noted were of particular concern. At the same time, it risks potentially excluding less profitable companies that may well be of public interest, such as those that provide key UK public services, but are below the size thresholds specified.

It is FIA EPTA member's view that the tests proposed in the Consultation have not been properly developed to clearly align to those companies that are in fact entities whose impact on the UK employees, investors and people is truly a matter of public interest. The current PIE definitions do take into account the nature of a given entity's impact on the UK market, by capturing listed companies, banks and insurance companies, which either seek funding from the public or provide essential products and services to the public. We would propose that any expansion of the UK companies that would be classed as PIEs rely less on the size of the entity and instead be based on meaningful qualitative criteria similar to those in the existing PIE definition. Possible criteria could be based on whether the company has more than a certain number of UK clients, whether the company has external investors (a key concern the Consultation refers to in various sections) whether the company provides public services, whether a company is a government contractor more generally, and whether the company has unfunded pension liabilities above certain thresholds. Such an approach would more adequately consider actual risks posed by specific companies than a definition based on size alone.

Furthermore, we note that the Consultation characterizes determining PIE status based on the size of the company as being proportionate. FIA EPTA members acknowledges that while the criteria in Option 1 and Option 2 in the Consultation can be deemed to be proportionate based on a company's size, the criteria are not proportionate when viewed from the perspective of whether the obligations proposed in the Consultation are applied to companies based on the impact they could have on UK employees, investors or the broader public. FIA EPTA members would urge the government to consider proportionality based on impact to UK employees, external investors and the public as a more well-tailored metric for considering which entities ought to be classified as a PIE.

Finally, given the significant obligations that are proposed to apply to PIEs, bright-line numerical criteria to determine whether a company is a PIE or not would also act as a deterrent to growth or expansion for companies near the thresholds for being classed as a PIE. UK companies near the thresholds could seek to manage employee numbers and limit growth to avoid being classed as a PIE, with a potentially chilling effect on UK employment, growth and investment in the UK. FIA EPTA members note that unintended

consequences for growth in the UK market should be considered carefully and balanced against the risks the Consultation aims to address in the context of developing the criteria for PIEs.

Question 2: What large private companies would you include in the PIE definition: Option 1, Option 2 or another? Please give your reasons.

Notwithstanding our answer to question 1, to the extent the decision is taken to include large private companies as PIEs, FIA EPTA supports Option 2 as the more appropriate measure of a large private company for a number of reasons, including most notably that the balance sheet is not a relevant or particularly fixed measure of a firm's size or impact on the UK economy. The balance sheet is a point in time metric and, particularly in the case of financial firms, varies significantly during the course of a year. Rather than representing relatively fixed assets, as may be the case for a high tech manufacturing firm, in the case of financial services firms balance sheet assets reflect market activity and changes in the market value of tradable assets and can reflect both long and short positions that increase balance sheet size, but are not a particularly meaningful measure of market risk, credit risk and bear potentially no relation to the size of a company's investor base. The second leg of Option 1 risks catching companies with few employees, and potentially very little impact on the UK market, which seems disproportionate to the issues the consultation aims to address. It also poses challenges for companies such as FIA EPTA members where balance sheet size does fluctuate significantly in any given year and from year to year.

Nonetheless, as noted in our response to question 1, FIA EPTA members do not believe that Option 2 offers a particularly well-calibrated, appropriately proportionate criteria for public interest. FIA EPTA prefers Option 2 only on the basis that it is at least potentially less inaccurate than Option 1.

Question 10: Do you agree that the Government should provide time for companies to prepare for the introduction of a new definition of PIE?

To the extent the Government does decide to expand the definition of PIEs as set out in the consultation, FIA EPTA members fully support the Government's proposal to allow a significant lead-time before introducing a new PIE definition.

Question 11: Do you agree that the Government should seek to offer a phased introduction for a new definition of PIE?

To the extent the Government does decide to expand the definition of PIEs as set out in the consultation, FIA EPTA members fully support the Government's proposal to offer a phased introduction for a new definition of PIEs.

Question 14: If the framework were to be strengthened, which types of company should be within scope of the new requirements?

FIA EPTA members support a proportionate approach to the implementation of any internal control requirements.

As noted above, 21 out of 30 FIA EPTA members are currently regulated by the FCA and as such are subject to robust regulation regarding their internal control frameworks as well as requirement public disclosures (referred to as Pillar 3 disclosures) regarding their risk framework and controls. The Consultation acknowledges that some large private companies are subject to existing PRA and/or FCA regulation and

acknowledges that the proposals in the Consultation should be coordinated within the wider regulatory framework in the UK and should ensure that the regulatory burden imposed on capital market participants is proportionate. FIA EPTA members support this approach and propose that it be developed into a meaningful set of guidelines to ensure that firms that are already subject to robust regulation regarding a range of areas, including internal control frameworks, risk management, operational resilience programs and related disclosures that have been specifically designed to address the risks those firms pose are not subject to additional and slightly differing obligations. Adding an additional, and slightly different, set of requirements regarding internal controls and specified public disclosures regarding such controls would be disproportionately burdensome given the risks such firms might pose are already subject to calibrated, proportionate regulation.

A further related point that we believe supports a qualitative understanding of what constitutes a public interest company and/or the appropriateness of applying all of the provisions of the Consultation to regulated firms relates to whether or not the Consultation is inconsistent with the position taken by other departments in Government regarding the risks posed specifically by financial firms to the UK economy. The Consultation specifically states that a key rationale for the proposed PIE definition as follows:

"The Government believes that the size of a company is a significant factor in determining whether it is a public interest entity. Larger companies tend to have a higher number of employees, creditors and investors with greater social and economic impact ***should they fail****"*.

FIA EPTA members note that the risk and potential consequences of any failure of FCA regulated firms is a matter that was specifically considered by HMT in the HMT's recent response to its consultation on Implementation of the Investment Firms Prudential Regime and Basel 3 standards consultation – published on 21 June 2021. In that response, HMT specifically concludes that FCA-regulated investment firms should be excluded from the scope of the UK resolution regime[1]. This is because HMT notes that an FCA regulated investment firm's nature, scale and complexity mean it is able to adequately wind down its business in the event of failure due to "*existing rules, supervision and tool kit that the FCA has in place (or will put in place through the IFPR), which are designed to ensure an orderly wind-down of these firms, as well as, the IBSAR, as the more appropriate tools for these firms*" (page 19 section 8.13 of HMT's recent CP response). This is a clear indication that HMT does not view the failure of an FCA investment firm as having a great impact on the UK from a social or economic perspective as well as a clear indication of their view that the existing regulatory framework is adequate to manage those risks. If an FCA-regulated investment firm becomes of systemic importance within the UK, it would then likely be PRA-designated and fall within the UK's Resolution Regime. This would mean that the PRA and the Bank of England would be able to manage its failure in an effort to maintain critical functions, protect public money, and protect financial stability; all of which would be within the public interest and reflect its increase in risk of social and economic impact should it fail. Given these the clear statements of HMT on the risks of failure of FCA regulated firms, we would urge the Government to ensure that any proposals to strengthen frameworks

[1] The HMT consultation specifically speaks of those investment firms currently subject to EUR 730,000 initial capital requirements under the EU Capital Requirements Regulation (GBP 750,000). This refers generally to those investment firms that are subject to solo FCA supervision, such as FIA EPTA members. The HMT consultation notes that their analysis under the soon to be implemented UK Investment Firm Prudential Regulation would be the same.

for companies in the UK is consistent with the position taken in other areas of Government and acknowledges and takes into consideration the true appropriateness of such requirements in the context of regulated financial firms, so as to avoid additional and unnecessary requirements that may make the UK a less attractive place for regulated financial firms to operate.

With that consideration in mind, FIA EPTA members would propose that large private companies that are already regulated by a UK relevant regulator (such as the FCA whose statutory operational objectives are to protect consumers, enhance market integrity and promote competition which are already aligned with the objectives of the Consultation) and so which face extensive existing internal control requirements under the regulatory regime, should not be unduly burdened by yet another layer of requirements that cover largely the same matters, but differ sufficiently to represent an additional obligation.

Furthermore, FIA ETA members note that the proposed enhancements to firms' internal control frameworks and the related disclosures proposed in the Consultation may be appropriate for those companies seeking external investors, those that employ considerable numbers of UK based employees, or that are UK government contractors, but are disproportionate and generally not relevant for privately owned, privately funded, regulated financial firms, which are not seeking external investment and are owned by a limited number of shareholders.

Question 30: Are there any additional duties that you think should be in scope of the regulator's enforcement powers?

FIA EPTA members note that the proposed basis on which the regulator will have power to bring enforcement actions against directors as set out in the Consultation appears to provide for potential strict liability for directors of breaches. We note that any liability for directors under the regulator's enforcement powers should align with existing standards for breaches, including requiring at least negligence on the part of directors.