Appearing to Act as a Shadow Director

Note by the Financial Conduct Authority to the Treasury Select Committee
Introduction

1 Our strategic objective is to make financial markets work well. To achieve this, Parliament has given us wide statutory powers over the firms and individuals we regulate. Operating within this mandate and using these powers, we have established a new judgement-based approach to regulation. This approach was set out in our October 2012 publication, Journey to the FCA.

2 The Parliamentary Commission on Banking Standards (PCBS) welcomed the creation of the FCA as a conduct-focused regulator, and our intention to deliver judgement-based regulation. However, the PCBS reported that ‘in exercising judgement in real time, regulators will need to steer a course which ensures that they do not assume a position as shadow directors and should bear in mind that it is the directors of banks, and not the regulators, who are answerable to shareholders’.

3 In their final report, Changing Banking for Good, the PCBS asked the FCA and PRA to examine how they will minimise the risk of appearing to act as shadow directors under their new approaches to regulation. This is our response to that recommendation.

Key points

- We will minimise the risk that we appear to be acting as a shadow director by operating within our eight principles for good regulation, being open and transparent in our new approach to regulation, and by following internal systems and controls.

- Journey to the FCA sets out how we will adopt a judgement-based, forward-looking supervisory approach that focuses on consumer outcomes rather than on compliance with rules. As part of this approach, we will make proactive interventions, through using our formal powers or supervisory judgement, to achieve our statutory objectives.

- Directors of regulated firms are personally responsible for ensuring that their firms treat customers fairly. If we have concerns, we will give senior management the opportunity to find appropriate solutions and take the necessary action. However, we will need to intervene on occasion, and this may constrain or direct the actions of boards and senior management.

- We do not consider that the actions we take within our statutory framework can be interpreted by the courts as the actions of a shadow director under the Companies Act definition.

- We are committed to ensuring that directors of regulated firms are held accountable for the fair treatment of customers. In 2014, we will consult on the new Senior Management Regime for the regulation of individuals within banks, as recommended by the PCBS, and will review the existing Approved Persons Regime for non-banks.

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1 Detailed on page 4  
2 http://www.fca.org.uk/about/why-we-do-it/our-remit/principles
Our approach

4 Parliament has given us wide-ranging powers to intervene in the operation of firms or markets, to achieve our statutory objectives. Like the FSA, we have the powers to:

- grant, refuse, vary or cancel permission for firms or individuals to carry out FCA-regulated activities
- impose requirements on firms to undertake or cease a particular action
- take enforcement action against firms and individuals when regulatory standards are breached.

5 In the Financial Services Act 2012, Parliament gave us additional powers, including early product intervention, advertising and competition powers. These are required to enable the FCA to achieve its statutory objectives and include powers to:

- block an imminent product launch or stop an existing product
- require firms to withdraw or amend misleading financial promotions with immediate effect
- impose requirements on certain unregulated parent undertakings that exert influence over authorised firms.

6 Our supervisory approach, as set out in the Journey to the FCA, is to develop and maintain a clear understanding of regulated firms’ business models, strategy, culture, products, operations, governance and prudential health. We use this knowledge to take an informed, forward-looking, evidence-based approach to identify the most urgent and important current and emerging risks to consumers and markets, and we apply our formal powers, our supervisory judgements, and our influence to achieve our objectives. We will at all times work within our statutory mandate and will not be looking to act (or appear to act) as a shadow director.

7 We operate a new supervisory approach based on three pillars - a Firm Systematic Framework, event driven work and thematic work on issues and products that may put consumers at risk.

8 The Firm Systematic Framework is based on business model and strategy analysis that aims to answer the question ‘are the interests of customers and market integrity at the heart of how the firm is run?’ This is based on four modules:

- governance and culture, which assesses how effectively the firm identifies, manages and reduces conduct risk
- product design, which looks at whether the firm’s products or services meet customer needs and whether customers are targeted accordingly
- sales processes, which are an assessment of the firm’s systems and controls
- post-sales handling, which looks into how effectively the firm ensures that its customers are treated fairly after the point of sale, service or transaction, including complaints handling.

9 Across the three pillars of supervision, a key part of our new approach to regulation is that regulated firms will be expected to devise and implement their own means to achieve outcomes that support our objectives. Where firms or markets are unable to devise their own means of achieving outcomes that support our objectives, we will take a more hands-on approach, including using our statutory powers if necessary.

10 Examples of our new regulatory approach having had major implications for the board and senior management of firms include our actions regarding interest-only mortgages, Santander SVR cap margin rises and mobile phone insurance. These actions were necessary to carry out our statutory duty and protect consumers.

**Interest-only mortgages**

In May 2013, we alerted both lenders and 600,000 interest-only borrowers to potential future problems with capital repayment.

- Market research revealed that just under half of interest-only borrowers had a shortfall in their repayment strategy and one in ten had no strategy in place at all.
- We worked with the Council of Mortgage Lenders and the Building Societies Association to ensure lenders wrote to borrowers to prompt them to check their repayment plans and consider the options available to them.
- Our pre-emptive action resulted in firms giving a ‘wake-up call’ to interest-only borrowers, encouraging consumers to take action now to prevent harm from occurring in future.

**Santander SVR cap margin rises**

In April 2013, we agreed with Santander UK that they would contact 270,000 mortgage borrowers affected by a SVR cap margin rise in 2008.

- In 2008, Santander increased its SVR cap margin rate from 2.5% to 3.75% but failed to clearly explain the implications to borrowers. So borrowers may not have understood their options, which may have included opportunities to move their loan to a lender offering a lower rate, or to exit their mortgage without incurring an early repayment charge.
- As a result of our action, Santander wrote letters to borrowers that explained the implications of the 2008 action and the possible impact of not being provided with clear information in 2008, and established a hotline to deal with inquiries.

**Mobile phone insurance**

In June 2013, we intervened in the mobile phone insurance market to improve poor practice that we identified in a thematic review.

- Our review identified that mobile phone insurance can be useful, but that poor practice existed in a number of areas: elements of the products were not designed to meet customers’ needs, some terms and conditions were unclear and unfair, and there were examples of poor claims and complaints handling.
- Having identified that many mobile phone insurance policies were not giving consumers the protection they expected, we engaged with firms to get them to make changes. This included changes in product design, revising terms and conditions to make them clearer and fairer, and adjusting claims handling processes.
- We believe that our intervention, which did not rely on formal statutory powers, will result in consumers getting a fairer deal.
Shadow directors

11 It is clear from recent history that the boards and directors of banks cannot always be relied on to do the right thing for consumers or markets. This conclusion was part of the reason the FCA was created. Our approach to regulation seeks to avoid a repeat of past consumer and market failures, such as PPI and LIBOR. Where we need to intervene to protect consumers and markets, we will do so.

12 The appearing to act as a shadow director point appears to be a proxy for directors believing that they are being put into a position by the FCA where their scope for decision-making is restricted. That is – in fact and in law – the role of the FCA, in much the same way that any other regulatory and legal framework operates, by governing the behaviour and actions of directors.

13 The law relating to shadow directorship is intended to capture those individuals who are in fact acting as directors but are not appointed as such and are therefore seeking to evade the statutory framework for directors. The legal concept of a 'shadow director' exists to ensure that the Companies Acts apply to these individuals and was not intended to apply to regulators acting within their statutory framework.

Minimising the risk of appearing to be a shadow director

14 The Financial Services and Markets Act (FSMA), amended by the Financial Services Act, requires us to consider eight principles when carrying out our work. Operating within these principles will minimise the risk of us appearing to act as a shadow director.

- Efficiency and economy – using our resources in the most efficient and economical way.
- Proportionality - ensuring that any burden or restriction that we impose on a person or activity is proportionate to the benefits we expect as a result.
- Sustainable growth - ensuring there is a desire for sustainable growth in the economy of the United Kingdom in the medium or long term.
- Consumer responsibility - consumers should take responsibility for their decisions.
- Senior management responsibility - a firm’s senior management is responsible for the firm’s activities and for ensuring that its business complies with regulatory requirements. This secures an adequate but proportionate level of regulatory intervention by holding senior management responsible for the risk management and controls within firms. Firms must make it clear who has what responsibility and ensure that its business can be adequately monitored and controlled.
- Recognising the differences in the businesses carried on by different regulated persons - where appropriate, we exercise our functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons subject to requirements imposed by or under FSMA.
- Openness and disclosure - we should publish relevant market information about regulated persons or require them to publish it (with appropriate safeguards). This reinforces market discipline and improves consumers’ knowledge about their financial matters.
- Transparency - we should exercise our functions as transparently as possible. It is important that we provide appropriate information on our regulatory decisions, and that we are open and accessible to the regulated community and the general public.
15 In addition to these principles, the following governance, processes and procedures will mitigate the risk of us appearing to act as a shadow director:

- applying appropriate FCA governance and management oversight that considers and reviews evidence and supervisory judgements, and using formal powers
- transparently engaging with, and responding to, comments and objections from directors of regulated firms
- providing monitoring and oversight by the FCA board and the four practitioner panels as part of the operation of the new regulatory approach
- addressing complaints, following freedom of information procedures, and carrying out formal supervisory reviews and audits.

Conclusion
16 We are mandated by parliament to intervene in the operations of regulated firms and markets in support of our statutory objectives. The risk of appearing to act as a shadow director is minimised by us acting transparently within our statutory mandate and principles for good regulation.

17 Directors of regulated firms are responsible for ensuring that they treat their customers fairly. In 2014 we will consult on a new framework for the regulation of individuals to promote individual accountability.

18 We will keep our approach under review, considering industry feedback such as the FCA Practitioner Panel Survey. PCBS has also recommended that the TSC review our approach to supervision in 2016.

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5 http://www.fs-pp.org.uk/publications/surveys.html