

Good Practice Guide Addendum



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Research and Due Diligence up-date for Advisers using Discretionary Investment/Fund Managers (DIMs/DFMs) to provide investment services under the 'agent as client' operating framework (COBS 2.4.3)

The FCA has reviewed this document and understand the market may benefit from the clarity of the advisers position in the 'agent as client' framework.

The views expressed in this up-date regarding MiFID II are those of the PFS, which are based upon the current consultation papers. The FCA cannot comment on MiFID II or pre-empt the forthcoming policy statement. The PFS will issue a further up-date when the policy statement is available.

Whilst this up-date is for Advisers who have signed an 'agent as client' agreement with a DIM, it may also be of interest to compliance departments of DIMs, Platforms, compliance consultants and SIPP providers. The FCA's proposed MiFID II rules (particularly on suitability, client reporting and product governance) will prompt reconsideration – and possibly 're-papering' - of client terms and operating frameworks so now is a good time to act.

From discussions and research within the retail investment sector, it is apparent the understanding of the Advisers' requirements within the 'agent as client' operating framework is not as clear as it should be. This has implications for all entities associated with clients' assets being managed this way.

In response to our questions, the FCA has confirmed the DIM can only treat the Adviser firm as its regulatory client if the Adviser is acting in a genuine agency capacity, and has been appointed by the client accordingly. Further, where an Adviser engages a DIM as agent for its underlying client, it is the Adviser as agent that is giving the DIM authority to act (assuming that is within the Adviser's agency authority).



The DIM's position

The rules allow for the DIM to treat the Adviser as their client for regulatory purposes (although the legal position is unaffected (COBS 2.4.2)) but do not make clear the requirements of the Adviser to be the client of the DIM. The Adviser may be treated as a 'professional client', but such Advisers need to understand the implications.

DIM intermediary agreements may make clear the DIMs are treating the Adviser as their client (which, unless categorised as something else, will mean a 'per se professional client' under COBS 3.5.2(b)). It is usually the Advisers' responsibility to ensure they have the appropriate authority to act in this manner. Typical wording in intermediary agreements says things like:

- The discretionary investment manager will treat the Adviser as its client for the purposes of the FCA Rules
- The discretionary investment manager will categorise the Adviser, in accordance with the FCA Rules, as a per se Professional Client
- The Adviser warrants that it will appoint the discretionary investment manager to manage Investor assets under the Service where such Investors have expressly appointed the Adviser to act as their agent in relation to agreeing the provision of this Service
- The Adviser firm is authorised and regulated by the FCA...the Adviser firm acknowledge that they are solely responsible for ensuring that, in using the service, the Adviser firm acts within the authorisations and scope of the Adviser firm's permitted business with the FCA
- The discretionary investment manager does not have any obligation to ensure that the Adviser is in compliance with any rule or requirement of the FCA.



The background

The ‘agent as client’ framework was reviewed and maintained 10 years ago when implementing MiFID’s original client categorisation requirements. The decision was taken then to retain this rule because (apparently) of the ‘strong practical benefits – particularly in the context of more complicated financial services involving ‘chains’ of parties’ – (see the FSA’s August 2006 paper on Implementing MiFID’s Client Categorisation requirements, paragraph 5.7, which pre-dated RPPD (see below))¹. It has not been reviewed since then, whilst the application of the framework in the market has moved on considerably. We are not aware of any plans to review the ‘agent as client’ framework as part of FAMR, MiFID II implementation or HMT’s consultation on the ‘definition of advice’ and it has not formed part of the FCA’s on-going wealth management suitability review.

The Regulatory Guide, The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD), initially published in 2007, outlines the principles that apply when there is more than one firm in the supply chain. Paragraph 1.16, for example, states: “Whether providers and distributors can agree between themselves how to apportion responsibilities between themselves will depend on the circumstances. In particular, it depends on the nature of the regulatory responsibility, the extent to which such an agreement would be reasonable, whether the arrangement is clear to both parties and properly recorded and the systems and controls used to monitor whether the agreement continues to be appropriate in the circumstances”.

The growth of business in this sector – mainly MPS (Managed or Model Portfolio Services) but not exclusively – warrants a review to ensure all parties involved are clear about their respective responsibilities, with appropriate controls and oversight in place to mitigate any risks to which the Adviser or the investor is exposed. It will also assist in understanding and implementing the new MiFID II proposals.

¹ At para 5.4, the FSA’s paper said: “Article 20 [the MiFID ‘reliance on others’ rule] also clarifies that the mediating firm remains responsible for the appropriateness [and suitability] of any recommendation ensuring that the client receives the necessary protections in these circumstances”; “The agent as client rule is available where the agent is not an authorised person.” (this appears outdated and no longer appropriate); “Where an arrangement is covered by COB 4.1.5R [‘agent as client’], the investment firm can treat the mediating firm as its client and must comply with the conduct of business provisions which attach to the client category of that agent – not the underlying client. If the agent is subject to conduct of business requirements in providing services to its client, it must comply with the requirements relevant to the services it provides to its client.” (This is stating the DIM can treat the Adviser as their regulatory client and if so must treat the Adviser as a ‘Professional Client’. The Adviser must comply with the conduct rules relating to the services it is providing to its client. In this case, acting as the agent, not simply advising on and arranging the investment).

MiFID II

The consultation papers on MiFID II (particularly CP 16/29 - <https://www.fca.org.uk/publication/consultation/cp16-29.pdf>) contain proposals to reform COBS 9 suitability requirements, introduce additional reporting for portfolio management and introduce the new Product Intervention and Product Governance Sourcebook (PROD) which will impact upon both DIMs and Advisers. PROD will build on the existing guidance within RPPD, clarifying the responsibilities of the manufacturer (of investments i.e. financial instruments) and the role of the distributor (of 'investment services', including the DIM) when providing products and services to the "end client" (a new defined term, meaning the 'person at the end of the supply chain').

For example, investment firms will need to enter into a written basic agreement 'to provide legal certainty and enable clients to better understand the nature of the services provided (new COBS 8A.1.3). This will include professional clients and, for portfolio managers, the agreement must set out the types of instruments that may be bought and sold and the transactions that may be undertaken as well as any instruments or transactions prohibited.

A firm providing portfolio management will have to undertake a suitability assessment 'for all decisions whether to trade' and whenever recommending or requesting that a client agrees or alters a mandate (new COBS 9A.2.2-3).

New COBS rules will require firms to identify the subject of a suitability assessment. Where a client is a legal person (such as an Adviser), the investment firm (ie the DIM) shall have a policy as to who should be subject to the suitability assessment and how this will be done in practice. The financial situation and investment objectives of the underlying client should be considered, whereas the knowledge and experience of the representative shall be assessed. In its response to CP 16/29, MiFID Consultative Paper III, the WMA has sought clarification from the FCA that this does not apply to the 'agent as client' framework.

New COBS Rule 16A 4.3 requires firms to report (to the client) when a client's portfolio depreciates by 10% or more, no later than the end of the business day in which the threshold is exceeded. This rule also applies if specific financial instruments held within the portfolio depreciate by 10% or more.

The proposed PROD 3.3 rules will apply to the distribution of 'investment services' such as 'portfolio management' and require the distributor to 'assess the compatibility of the financial instruments with the needs of the clients to whom it distributes investment services, taking into account the manufacturer's identified target market of end clients'. Distributors will have to 'identify any groups of end clients for whose needs, characteristics and objectives the investment service is not compatible' (PROD 3.3.15(3)). They will have to ensure all applicable rules are complied with, including disclosure (COBS 4 and 14) and suitability (COBS 9).

In chains of distributors, PROD 3.3.32 will require a firm that distributes to end clients to ensure compliance with the PROD chapter in respect of the service it distributes to end clients. A firm which distributes financial instruments to clients which are not end clients, must consider whether it is undertaking a manufacturing role and, if so, comply with PROD 3.2.

The MiFID 'reliance on others rule' (COBS 2.4.4 – which will remain largely unchanged) is an operating model worth considering. Not without its challenges, it currently meets many of the objectives of the Adviser and DIMs when working together to provide a service to the same client. Going forward it should meet with the requirements of MiFID II.

The timeframe for the implementation of MiFID II is already very tight. We recommend members who are currently operating under an 'agent as client' model give this update due consideration and take the opportunity afforded by the rule changes to review and, if necessary, regularise their distribution arrangements and agreements (with DIMs and clients).



What should Advisers consider doing now?

Check the intermediary agreement you have signed. Is it on the basis of 'agent as client'? Please note COBS 2.4.3 R (2)(a) whereby the DIM may 'break' the agent as client rule by agreeing in writing with the Adviser to treat the underlying principal (ie the investor) as their client.

If in any doubt ask the DIM to complete section 2 of the Research and Due Diligence Question Sets published by Diminimis/PFS, available on the PFS web site

http://www.thepfs.org/media/7006480/3_mps_on_platform__100516.pdf

Does your client agreement give you the level of authority required? Our research suggests many Adviser agreements are limited to 'advise on and arrange (bring about) deals in investments' and do not go as far as the ability to commit and bind your client to the discretionary management agreement. As such Adviser agreements tend to be of an advisory nature.

If you would like to continue with the agent as client operating framework it is recommended you;

- Ensure your client agreements give you the necessary authority to commit and bind the client to the discretionary management agreement
- Speak to your legal/compliance team to get their advice on your existing or proposed framework(s) going forward, having considered the implications of the FCA's MiFID II proposals
- Ensure you have the appropriate controls and oversight, along with the capacity and expertise, to meet your responsibilities
- Check your PI insurance covers your firm when using this operating framework
- Consider requesting the DIM re-classifies you, or agrees to treat you, as a 'retail client' if appropriate.

Acting as a 'professional client' brings with it issues you must be aware of and potentially may require you to have specific controls and oversight to ensure your retail clients are not exposed to levels of risk that you as a professional client may be exposed to (see, for example, the recent FCA warning <https://www.fca.org.uk/news/news-stories/pension-scheme-operators-risk-smarter-scams>). New COBS 9A.2.22(5), regarding restrictions on retail distribution, will say that 'if promotion of a financial instrument to a retail client would not have been permitted, then the discretionary manager's decision to purchase it on behalf of the retail client should be supported by detailed and robust justification of his assessment of suitability'. There are other issues to consider such as the lowest level of investor protection and limited access to FOS (at least against the DIM, leaving the Adviser exposed) in case of complaints.



Diminimus Suitability Matrix – May 2017 Update

Operating Framework		DIM Suitability		Investment Suitability			Ongoing Suitability		
		Appropriateness of DIM service for the client	Selection of DIM	Suitability of initial client portfolio construction	OR Suitability of portfolio selection	Suitability of transactions to portfolio mandate	On-going suitability of portfolio	Ongoing monitoring of DIM service	Ongoing monitoring of DIM selection
Model A Direct DIM engages the client as a retail client	Standard bespoke	Adviser	Adviser	DIM	N/A	DIM	DIM	Adviser	Adviser
Model B Hybrid DIM relies upon the client information and assessment by the adviser	(a) Standard bespoke	Adviser	Adviser	DIM	N/A	DIM	DIM	Adviser	Adviser
	(b) DIM relies upon the client information and assessment by the adviser AND portfolio selection	Adviser	Adviser	Adviser	Adviser	DIM	Adviser	Adviser	Adviser

Model A: The advisory firm arranges for the client to have a direct (contractual) relationship with the DIM.

Model B: based on the MiFID rule 'reliance on others' (COBS 2.4.4); The advisory firm arranges for the client to have a direct (contractual) relationship with the DIM but the DIM relies on the client information provided, and an appropriateness assessment by the adviser. B (b) the DIM is also relying on the advisory firm to select the portfolio construction from a range of pre-defined strategies.

Diminimus Suitability Matrix – May 2017 Update continued

Operating Framework		DIM Suitability		Investment Suitability			Ongoing Suitability		
		Appropriateness of DIM service for the client	Selection of DIM	Suitability of initial client portfolio construction	Suitability of portfolio selection	Suitability of transactions to portfolio mandate	On-going suitability of portfolio	Ongoing monitoring of DIM service	Ongoing monitoring of DIM selection
Model C Agent as client DIM does not have a direct relationship with the underlying investor	MPS On Platform	Adviser	Adviser	Adviser	Adviser	DIM	Adviser	Adviser	Adviser
Model D Outsourced Solution	Standard	Adviser	Adviser	Adviser	Adviser	Adviser	Adviser	Adviser	Adviser

Model C: based on the ‘agent as client’ rule (COBS 2.4.3); The advisory firm arranges for the investment management to be carried out by the DIM but on the basis the client does not have a contractual relationship with the DIM. Instead, the DIM treats the advisory firm as its client, which is acting as the agent of the end investor. The advisor firm must have the appropriate authority from their client to be able to commit and bind them to the discretionary management agreement and thereby to appoint the DIM. In addition, it is highly recommended the adviser firm has the appropriate controls and oversight, along with the capacity and expertise, to meet their responsibilities. Additional responsibilities may apply if the adviser firm is treated as a professional client.

Model D: This is the only true ‘Outsourcing’ option. It can only be used by advisory firms who hold the relevant permissions for managing investment and delegate the investment management to the DIM. The responsibility for all aspects of the investment solution remains with the adviser firm*

**SYSC8; If a firm outsources critical or important operational functions or any relevant services and activities, it remains fully responsible for discharging all of its obligations under the regulatory system.*