Financial Services Authority

Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers

Good practice illustrations for managers of UK authorised collective investment schemes relating to certain provider responsibilities identified in PS07/11 'Guidance on Responsibilities of Providers and Distributors for the fair treatment of customers'

January 2008

1 Overview

Introduction and scope of the good practice illustrations

In July 2007 we published a Guide on the responsibilities of providers and distributors for the fair treatment of customers (the 'Guidance'). In the accompanying policy statement (PS07/11) we recognised that:

'*there may be some difficult or complex areas where case studies (or at least additional clarification of what we expect of firms) may be helpful. So we intend to consider on a case by case basis whether further clarification is required in any particular area, and if so, what the best form for that clarification is*'.

In line with this commitment, we have decided to clarify, by providing practical examples, the application of certain responsibilities in the Guidance to managers of UK-authorised collective investment schemes (UCITS, Non-UCITS retail schemes or QIS).

The Guidance sets out a number of provider responsibilities throughout the life-cycle of a product. These include responsibilities relating to:

- product design (para. 1.17);
- provision of information to distributors (para. 1.18);
- provision of information to customers (para. 1.19);
- selecting distribution channels (para. 1.20); and
- post-sale (para. 1.21).

The Guidance applies to managers of UK authorised collective investment schemes as it does for other regulated firms. However, we recognise that two of the responsibilities we specify in the Guidance have given rise to questions from the asset management sector, particularly managers of collective investment schemes (CIS). These firms are operating in an increasingly dis-intermediated sector, where the use of nominee accounts is widespread and over 80% of fund sales are made through channels that are not controlled by the CIS manager. These factors complicate the distribution chain significantly and result in situations where

consumers (including details of their portfolios) are often not known to the CIS manager. Further, these funds are obliged to comply with existing regulation, such as the COLL sourcebook which places a number of requirements on the fund and manager. Also, funds are designed to be used in various ways, for example, singularly or as part of a portfolio. They are therefore created with specific risk/return characteristics rather than targeting a particular demographic.

Accordingly, we are publishing this good practice illustration to consider the application of these two responsibilities only, which are:

- when undertaking product or service design a firm should identify the target market, namely which types of customer the product or service is likely to be suitable (or not suitable) for (1.17(1)); and
- when selecting distribution channels, a firm should review how what is occurring in practice corresponds to (or deviates from) what it originally planned or envisaged for the distribution of its products or services given the target market. This involves collecting and analysing appropriate Management Information (MI) so the firm can detect patterns in distribution as compared with the planned target market, and can assess the performance of the distribution channels through which its products or services are being distributed (1.20(2)).

This good practice illustration is intended for managers of UK authorised collective investment schemes (UCITS, Non-UCITS retail schemes or QIS). It applies equally to funds distributed directly by CIS operators, or those bought on an advised or non-advised basis and funds administered through other nominee accounts, whether to be administered on a platform or through an open architecture product. It does not necessarily read across to providers of unit-linked or with-profits funds, which in many cases may be sold in such a way as to be characterised as 'pension' or 'lifestyle' products, though others do directly compete with collective investment schemes. Nor does it read across to other business models. In addition, we have assumed, unless otherwise stated, that collective investment schemes are not of the type that might be described as 'structured' products, having a defined lifespan.[1]

We have drafted this good practice illustration in collaboration with the industry, following a 'working group' that met twice during December 2007. It represents existing good practice many firms already undertake regarding these two provider responsibilities. It is important for firms to bear in mind that in drafting these illustrations we have taken into account existing market practice. We would emphasise that firms should be proportionate when considering how to implement the relevant standards.

1. This good practice illustration may be of interest to discretionary and advisory portfolio managers, wealth managers, investment advisers and other distributors of investment products, including platforms, and in fact, the working group comprised representatives of each of this type of firm. However, this is not directed specifically at these types of firms.

Target Market – Good practice for para. 1.17(1) of the Guidance

‘*When undertaking product or service design a firm should identify the target market, namely which types of customer the product or service is likely to be suitable (or not suitable) for.*’

Good practice includes:

1. **The target market of a particular fund being characterised by identifying certain criteria or parameters which could include risk characteristics and likely investor usage/needs that the fund would fulfil – e.g. around likely investment viewpoint; risk appetite; proportion of portfolio; and time horizon.**

   This is more than just describing the fund characteristics and risks, but it does not require targeting to a particular demographic profile. Also, considering the criteria of those risk characteristics and investor usage/needs that the fund would **not** fulfil can be useful in demarcating the appropriate ‘target market’ (e.g. an emerging markets smaller cap long-only fund is unlikely to fulfil the needs of investors with low risk appetite).

   The following factors are considered in creating the fund, and subsequently, the main elements of any characterisation will typically be described in the Simplified Prospectus, or equivalent disclosure material. But ancillary marketing and training material might also usefully capture some of these factors, including a description of:

   - what the fund is for, the investment viewpoint that is encapsulated in the fund strategy (which will typically vary according to investor’s time-horizon), the nature and scale of risks presented by the fund that might be relevant to its selection such as liquidity, volatility and/or risk of capital loss and a realistic typical investment time-horizon; and
   - whether the fund would best be incorporated as part of a portfolio of investments.

2. **Considering, and if appropriate limiting the means of distribution of the fund.**

   Firms have strong relationships with their key distributors that are based on regular contact including product knowledge training and marketing to those firms, which will include platforms and advisers amongst others. A firm has a good understanding of the business models (including typical client base) of those distributors when determining how it will actively distribute, for example, a fund that has been designed to express an unusual or esoteric investment viewpoint. We expect firms to consider whether the nature of the fund is such that it might be necessary to limit or otherwise restrict its active distribution, including:

   - to direct retail customers – not issuing direct offer financial promotions, asking direct investors whether they have received advice and suggesting that they do so;
   - to a subset of the distribution population; and
   - via a fund supermarket or wrap platform.

REVIEWING HOW WHAT IS OCCURRING IN PRACTICE CORRESPONDS TO (OR DEVIATES FROM) WHAT WAS ORIGINALLY PLANNED OR ENVISAGED – GOOD PRACTICE FOR PARA 1.20(2) OF THE GUIDANCE.

‘*When selecting distribution channels, a firm should review how what is occurring in practice corresponds to (or deviates from) what was originally planned or envisaged for the distribution of its products or services given the target market. This involves collecting and analysing appropriate Management Information (MI) such that the firm can detect patterns in distribution as compared with the planned target market, and can assess the performance of the distribution channels through which its products or services are being distributed (1.20(2))*’.

Good practice includes:

1. **Considering the information needs of distributors, such as:**
   - building an understanding of key distributors, including through training processes and other contact (eg sales & marketing and client relationship management activities), as appropriate for particular funds;
   - taking steps to ensure understanding of the information needs of distributors and how performance characteristics and investment risks can be explained in a way that distributors are capable of understanding and using effectively during the sales and advice process; and
   - considering the aggregate level of understanding of its distributors when they are determining the appropriate type and extent of distribution for the fund (e.g. as a result of feedback from product knowledge training), and taking action accordingly (e.g. not actively distributing through them, or adjusting their communications with the distributor accordingly).
2. **Assessing the accuracy of the characterisation of the fund and its generic suitability *on an ongoing basis*, such as:**
   - keeping the distributors and customers informed on an ongoing basis of developments relating to the fund;
   - considering if the suggested original usage of the fund remains appropriate and that the performance of the fund is continuously compared to the initial/current characterisation of the fund. In this regard, a firm might:
     - o ensure that any disparity is reflected in changes to the relevant disclosure and marketing material;
     - o assess whether any disparity or development is so material that this should be communicated to investors and/or distributors (e.g. if documentation describes a fund as low risk, movements in the underlying asset type, strategy, sector or market which call this characterisation into question); and
   - assessing feedback on the content of marketing and training material related to funds, and amending material as appropriate to ensure it remains relevant and comprehensible.

3. **Collecting evidence that enables the monitoring of sales volumes and trends against projections, such as:**

- tracking sales volumes/trends to identify unusual trends in terms of sales volumes (including through particular distribution channels), so that a firm might, for example, investigate instances of particularly high sales volumes through individual intermediaries :
  - o this might be based on comparison with the average volume from individual intermediaries or based on a firm's past experience of that distributor;
  - o even though this might be more difficult in cases where sales are aggregated through the use of nominee accounts, whether on platform or by wealth managers, firms utilise any available information (quantitative or qualitative) to check disproportionately high level of sales; and
- proactively considering whether there are particularly useful measures to assess outcome against expectation, such as:
  - o comparison of firm experience against market-wide statistics;
  - o redemption patterns evidenced via directly invested holdings and any other data (e.g. qualitative) available from intermediaries; and
  - o complaints data, including analysing 'root causes' of complaints.

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