Consumer Duty and its impact on Product Governance and the Distribution Chain

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Introduction

This will be one of the areas where firms will need to consider their approach to the Consumer Duty most carefully. In the consumer investments world, the distribution chain can be extremely complicated and consist of multiple product manufacturers (both for the actual investment and associated wrappers), a platform provider, custodians, DFM, broker and/or financial adviser. Some of those will play a relatively minor role whereas others will have a significant role.

What does the Consumer Duty require?

The Consumer Duty consists of an overarching principle, cross-cutting rules and outcomes. There is not just one section or obligation that firms need to comply with when considering product governance and their distribution chains. However, the most immediately applicable is the new 'Product and Services Outcome' expected to be clearly demonstrable by firms as one of the four outcomes expected under the Consumer Duty. The relevant rules and guidance builds on PROD and will require firms to:

- Identify a target market (applicable to both manufacturers and distributors)
- Ensure the product or service design meets the needs, characteristics and objectives of that target market
- Ensure the distribution strategy is appropriate for the target market
- Obtain and share information along the distribution chain – including between manufacturers and distributors
- Carry out regular reviews and monitoring to ensure the product or services continue to meet the needs, characteristics and objectives of the target market

We expect that, in practice, firms will find that there is significant nuance in what may sound like simple requirements. For example, it may be that firms will need to tailor their service for different groups of clients within the target market. Vulnerable clients are an obvious example but, as firms know, vulnerability can arise in a number of circumstances, and challenges may arise for firms in ensuring they have captured vulnerability considerations sufficiently as part of their product governance and distribution processes.

The FCA recognises the concept of proportionality. This will likely involve firms considering what their role is in the distribution chain (i.e. the more involved they are, the more they will need to do to satisfy the Consumer Duty) and the level of risk to which their product/service exposes the retail clients (i.e. higher risk products will require more efforts to satisfy the Consumer Duty). Even this may not be as simple as considering the risk of any particular investment. For example, a pension sat in cash, which as an investment is considered very low risk, could be causing the individual reasonably significant 'harm' with inflation as high as it is at the moment (i.e. an effective loss of 8 to 9% per annum).

Definition of 'Product' in Consumer Duty v Position in PROD

It is important to understand the difference between PROD and the Consumer Duty. In some respects, for product manufacturers (such as fund managers) this should be 'easy'. PROD 3.2 already applies and the FCA has confirmed that, in relation to the Product and Services Outcome, complying with the relevant PROD rules will tend to be sufficient for establishing compliance for Consumer Duty purposes.

On this point, manufacturers will want to make sure they are achieving good outcomes with PROD given it has been in force for over four years and, as such, we would expect the FCA to take an increasingly dim view of any on-going failures.

Where it becomes far more challenging is *how* service providers should approach product governance with regards to the differences with PROD. We know there are varying approaches taken in the market as to:

1) What is captured by PROD 'manufacturing' and whether that is just products or also (some) services; and

2) Even if services are captured, what can or should be taken from the PROD manufacturing rules and guidance and applied to the design and delivery of services?

An obvious example is around model portfolio services ("**MPS**") – in a number of respects, they look similar to funds but they are a MIFID service rather than a UCITS or AIFMD product.

In relation to the specifics of PROD and its application compared with the product governance considerations arising from the Consumer Duty, we note the following:

- PROD 3.2, which deals with manufacturer responsibilities, largely only applies to 'Financial Instruments' (as defined) and services are not in and of themselves Financial Instruments.
- PROD 3.3.32 (2) states: "(2) A firm which distributes financial instruments to clients which are not end clients must, in addition to complying with the rules in this chapter, consider if they are also undertaking a manufacturing role and, if they are, also apply PROD 3.2." 'Manufacturing' references 'investments', defined as "any investment, including any asset, right or interest". This is a different definition than that which applies in PROD 3.2 – it is more arguable that a MPS, for example, is captured by this 'investment' definition.
- Firms can also take the view that no matter the position of PROD 3.3.32 (2), as PROD 3.2 applies mainly to Financial Instruments there is limited relevance to services.
- The new (draft) Handbook 'product' definition is "any specified investment, **or the provision of a service in the course of carrying on a regulated activity**, or an ancillary activity (particularly relevant for MiFID firms), distributed or to be distributed to retail customers and which, unless the context otherwise requires, is not intended to refer to an individual contract" [emphasis added].
- The draft definition of manufacturer will include "(3) (in PRIN) a firm which: (a) creates, develops, designs, issues, operates or underwrites **a product**" [emphasis added].
- The draft definition of distributor is "(in PRIN) a firm which offers, sells, recommends, advises on, proposes or provides **a product,** or otherwise makes arrangements with a view to a retail customer entering into an agreement for a specified investment" [emphasis added].

In our view, a firm will be deemed to be a manufacturer of a product under the Consumer Duty in more scenarios than under the current PROD regime. That is because 'product' includes services.

What does this all mean?

Clearly all relevant services such as MPS and/or platform services are captured under the Consumer Duty, whereas, there is uncertainty and/or different market approaches to these services and their status under PROD. For some firms, this could be a very large shift and create significant additional burdens in terms of processes and formalities. Whilst considerations will vary between products and services, we consider the distinction between manufacturer and distributor to be significantly more blurred in some contexts.

Firms which already comply with PROD 3.2 (the manufacturer's obligations), will want to consider if they are able to leverage current manufacturer policies and processes for their services. The same applies to PROD 3.3 (the distributor's obligations). Equally, firms may find it useful to consider PROD 3.2 for any useful guidance which they can apply in relation to services. On this, firms may try to take a literal view of the proposed PRIN 2A.3.28, which provides that a firm which is required to comply with PROD 3 must continue to comply with it and that can be relied upon as "tending to establish compliance" (with the Product and Services Outcome) and say that if they apply PROD 3.3 to services then that is sufficient. However, for the reasons given above, we consider the Consumer Duty ensures that manufacturer obligations apply to services in a way which is less clear under PROD. In our view, if a firm does not already apply these considerations to its services, it may be open to criticism notwithstanding that PROD may technically have been complied with.

Changes to 'Distribution under the Consumer Duty'

As part of complying with PROD 3.3, firms should already have a distribution strategy. Whilst each firm will know how it distributes its products, it is less clear how well documented this will be and whether it captures all the points required under the Consumer Duty. This should be reviewed and we would expect firms to ensure they:

- have set out the target market(s) for the firm's services and products, including understanding the difference between groups within the target market(s);
- understand the roles and risks arising from the roles that each third party plays in the distribution chain;
- have identified the client's information needs relating to the product/service and what support consumers may need to properly enjoy the benefits of the product or service being provided to the client;
- add periodic reviews as part of the compliance monitoring programme to ensure continued compliance. Firms will also need to decide what may cause an ad hoc review to take place (such as root cause analysis indicating a group of clients are receiving poor outcomes);
- develop or leverage existing management information ("**MI**") with appropriate key risk and performance indicators related to distribution to be shared with senior management;
- document all of these steps as part of a policy or procedure to demonstrate how the Consumer Duty has been embedded; and
- consider:
    - the information flows between it and relevant third parties;
    - how third parties being onboarded as part of the process are assessed and monitored on an ongoing basis;

- how to monitor for good/poor outcomes and the requisite MI;
- appropriate contractual arrangements with third parties are in place and each is clear on their responsibilities; and
- obligations with regards to non-UK parties in the distribution chain, and where the end customer may not be UK-based.

A related point is that firms will want to have implemented a policy designed to capture and comply with manufacturing requirements for any of their products and services they manufacture. Because the product definition will now include a service, the distinction between manufacturing products and a distribution service may become blurred. Taking an IFA for example, its distribution service would presumably capture the investment products and services it distributes, whereas manufacturing requirements would only apply to its service of providing advice. In reality, there may be limited difference as, using the above example, the advisory service relates to the distribution of third party products and services and so it is likely more practical to take a holistic approach to determining any policy or process. There may be times this distinction is more important and, in any event, it may be significant to distributors who have not previously considered themselves as manufacturers of anything.

Additionally, where there are multiple firms working together to manufacture a product or service, firms must have a written agreement which sets out each of the parties' responsibilities. This should also clarify the extent to which firms in the distribution chain are responsible for meeting different requirements and their liability for failures. Even where firms are not co-manufacturing a service, where there are multiple firms in the distribution chain, firms will need to consider which parties they enter into contracts with and where it is appropriate to direct obligations via third parties. Where firms are seeking to rely on third party arrangements, they should undertake due diligence on these arrangements to ensure firms are meeting regulatory obligations. Again, the level of due diligence will vary depending upon the role of each party.

Conclusion

The above has focused on the Products and Services Outcome and what it requires. As established, there is overlap with Consumer Duty and PROD requirements, in addition to requirements to fulfil other aspects from the Consumer Duty. This means that even for firms seeking to rely on PROD 3 to establish their compliance with the Products and Services Outcome, there is still further work to be done.

Should you have any questions and/or would like to discuss any of the above, please speak to one of:

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