CP26/20: An in-depth review of the proposed Due Diligence requirements

Against a backdrop of continued market growth, increasing investment complexity, divergent SIPP products and heightened regulatory focus on consumer protection, the FCA proposes significant reform incorporating explicit due diligence obligations and a pension scheme money and assets regime.

These proposals are set out in CP 26/20: Adapting our rules for a changing market: self-invested personal pensions. As these proposals progress, we will be producing a number of articles. This article focuses on the proposed due diligence (**"DD"**) requirements under a new COBS 19A chapter, which cover (broadly): DD on relevant third parties, DD on investments, additional controls where third parties deal in, acquire or manage investments, and overarching governance requirements. These proposals are likely to have significant operational implications, particularly for 'bespoke / full SIPPs', and raise important questions about proportionality, commercial viability and investor choice.

When do the rules apply?

The proposed rules applies where a personal pension scheme allows the client to select investments for some or all of their pension assets. This includes where a client is able to allow a relevant third party to select investments. The rules do not generally apply where investment selection remains with the operator, such as investment pathways, lifestyle options or other pre-selected investment solutions. The FCA's rationale is that the risk of scams and fraud is lower where the operator retains responsibility for investment selection.

The consultation paper (**"CP"**) indicates this includes model portfolios (paragraph 3.16), but it is not clear that the rules as drafted (COBS 19A.1.2 (2) R) capture this (unless the model portfolio by default falls into a category of permissible investment or is only made up of investment funds and the rules are designed to 'look through' the model portfolio 'label').

Overarching Requirements / Observations (COBS 19A.1)

The purpose of COBS 19A is to reduce, *"as far as reasonably possible"*, the risk that clients suffer from scams, fraud or non-credible investment propositions. To achieve this, operators are expected to exercise ongoing vigilance and remain alert to information indicating potential consumer harm, which could require additional staff training. Equally, when sourcing information, operators must do so from independent sources wherever possible and avoid unreasonable reliance on information provided by third parties or investment promoters.

Agreements with third parties and understanding conflicts

The FCA also proposes new requirements governing relationships with relevant third parties. Before a third party can provide services within scope of the regime, operators must have a written agreement that clearly, and with sufficient detail, sets out the roles and responsibilities of the parties and any restrictions on the third party. They must also identify and manage ***any*** *"potential conflict arising from the relationships, holdings or positions of the relevant third party and the interests of the relevant client(s)"*, to ensure fairness and avoid undue risk to client interests. Where the third party can arrange / deal in investments within the scheme without operator involvement (see below), the written agreement will need to cover additional requirements.

Firms will want to consider the following:

- These requirements may require significant implementation work, particularly for operators with extensive third-party networks.
- Operators will likely want to develop standardised contractual documentation, which will need to align with their DD processes and internal risk policy.
- The broad requirement to identify *"any"* potential conflict will require a structured approach to conflict assessment, including consideration of third-party remuneration arrangements.

DD on Third Parties

Operators must undertake initial and ongoing DD on any relevant third party. For DD purposes, a third party is 'relevant' if they provide, or propose to provide, introductions or one or more services in relation to investments that are, or are proposed to be, held within a scheme. Examples of in-scope third parties include introducers, arrangers, advisers and discretionary investment managers.

The FCA proposes that all third parties must pass core DD with additional DD required for higher-risk third parties. These proposals and the key takeaways are summarised in the table below.

Application	Key Obligations	Observations / Practical Implications
Overarching / General Obligation (COBS 19A.2.2) *The overarching obligation is framed as a positive duty: operators must be satisfied, on a continuing basis, that engaging with the third party does not create undue risk to individual client pots.* *This goes beyond a reactive obligation to identify specific concerns (or to simply not have concerns).*	Operators may only enter into or continue arrangements where their DD provides *"reasonable assurance"* that the third party does not create undue risk to client SIPPs. The precise standard required and how the FCA refers to it in the CP does not entirely match. CP26/20 references twice that operators need to "*make sure the business they [the third party] conduct does not pose risks to consumers"* whereas the draft rule (COBS19A.2.2) requires *"the operator's DD gives it reasonable assurance that this will not involve undue risk to the individual pot…arising from the conduct of the relevant third party"*. Whilst similar, there is a mismatch in language around what the obligation means / requires which the FCA should clarify.	Where core DD is sufficient to satisfy this requirement, the obligations on operators are reasonably clear, potentially subject to the required conflict assessments. Where additional DD is required, this will be more challenging and operators will need to create their own frameworks. Where there is a wide range of services/roles undertaken by third parties, it is likely operators will want/need to map third parties to groups with their own DD processes tailored to take into account potential risks arising from each group. For SIPPs which offer access to a broad range of complex investments, resulting in a broad range of third parties, this will be particularly challenging with potentially significant implications for operational costs and pricing.

Core DD (COBS 19A)
 	
Applies to all relevant third parties.
 	
Where the third party is an FCA-authorised firm, completing core DD is sufficient to satisfy the DD obligations unless the "operator is aware, or reasonably should be aware, of information relating to the relevant third party that is indicative or suggestive of a material risk to clients' individual pots".
 	
If this applies, then additional DD Is also required.
	• Verify that the third party has appropriate regulatory authorisation (including in foreign jurisdictions);
	
	• Check for any disciplinary or criminal proceedings, investigations or convictions relevant to introductions or services provided;
	
	• Check against FCA and equivalent overseas warning lists; and
	
	• Assess that there is *"no scope"* for conflicts of interest to arise between the third party and close associates which cannot be managed to ensure fairness and avoids under risk to clients.
	
	Note: Where a third party is referenced, this also captures any *"director, senior manager, an approved person or appointed*
		Operators will need to:
		
		• Understand and assess required regulatory approvals of third parties (including any relevant overseas jurisdictions);
		
		• Consider what information they require to assess the conflicts requirement. This will likely include as a minimum:
		
		  ○ understanding the third party's business model and how it relates to the role it is playing with the scheme and/or investment;
		
		  ○ whether any associated parties are involved; and
		
		  ○ how the third party (and associated parties) are remunerated and/or otherwise have an interest in the provision of the service and/or the investment.

Application	Key Obligations	Observations / Practical Implications
	representative of the relevant third party where relevant to the provision of the introduction or service".	• Determine what amounts to information which indicates or suggests a material risk to individual client pots may exist such that core DD is insufficient. These checks would need to be completed before the business relationship commences. Owing to the definition of FCA authorised firm, operators that want to allow appointed representatives to provide relevant services would seemingly need to enter into a relationship with the principal if seeking to only carry out core DD.
Additional DD (COBS 19A.2.5) *Applies to non-FCA authorised firms (e.g. overseas third parties and unregulated introducers) and to FCA-authorised third parties where the operator is aware, or reasonably should be aware, of information indicative of a material risk to clients' individual pots.*	Operators must conduct additional DD where core DD alone is insufficient. This additional DD must be sufficient to satisfy the overarching DD obligation set out in COBS 19A.2.2. The FCA does not prescribe the checks required, instead firms must determine what additional information is necessary to satisfy the DD obligation in each scenario.	Operators will need to develop a framework which will allow them to determine what DD is required in each scenario. This framework may set out the minimum required but should also include a step for the firm to consider if there is anything else about this arrangement which requires further consideration. To make this workable, we would expect any framework to include key factual patterns / risk factors which may apply to third parties with which the operator deals. For each of these, the framework can set out the required DD. This will help firms to monitor compliance and ensure a minimum level of consistency. The consultation paper indicates adverse media screening and consideration of the third party's business model to identify unusual or riskier than expected arrangement as examples of the type of additional DD expected.
Ongoing DD (COBS 19A.2.7)	Operators are required to undertake ongoing DD periodically at *"reasonable intervals"*.	Whilst the rules do not prescribe a fixed review cycle, the FCA has indicated it expects DD to be reviewed at least annually, and more frequently where appropriate.
Adverse findings (COBS 19A.2.9 to COBS 19A.2.11)	Where operators can no longer be satisfied that a third party does not create an undue risk to clients' individual pots, the operator must not enter into or cease accepting business from that third party. The operator needs to consider and implement, *"reasonable steps to assess and mitigate the risk of harm to clients from prior business conducted with the relevant third party"*. This includes considering	Robust record-keeping will be critical. Operators should retain documentary evidence of checks undertaken (for example, screenshots, search results and other supporting records), rather than simply recording that no adverse findings were identified. This is particularly important given the FCA's proposal under COBS 19A.2.10 to delay certain actions where this is in clients' interests and/or would prevent the risk of harm to clients increasing.

Application	Key Obligations	Observations / Practical Implications
	what information should be provided to clients. This obligation would apply whether or not there is any fault with the operator. The proposed rules will allow operators to delay certain steps where, in their reasonable judgement, it is consistent with the overarching obligation to prevent undue risk to individual client pots.	Exercising that discretion is likely to involve difficult judgement calls, requiring firms to balance consumer protection against the risk of causing loss. Any reliance on this discretion requires the operator to *"clearly document its reasoning and keep that record indefinitely"*.

DD on SIPP investments

The proposed obligations are split between two distinct scenarios:

- COBS 19A.3 applies where operators carry out / arrange investments which they are instructed, by or on behalf of a client, to arrange or acquire in the scheme they operate.
- COBS 19A.4 applies where a third party, without the involvement of the operator, can carry out / arrange investments within the scheme.

Across both scenarios, operators are required to set out a *"clear internal policy on [their] risk tolerance"* which informs their approach to investment DD. Operators should consider whether DD will be conducted on a per-investment or per-investment-type basis and document the rationale for that approach. The principal obligations under COBS 19A.3 and COBS 19A.4 are summarised below.

Proposal and Application	Key Obligations	Practical Implications / Recommendations / Observations
General Investment DD Obligation (COBS 19A.3 / 19A.4)	Operators must put in place appropriate: • DD processes for investments where they undertake them; or • Investment parameters where third parties arrange for such investments without the operator's involvement. These processes / parameters must effectively identify assets or propositions that pose *"an undue risk of fraud, or are unlikely to be a credible investment proposition"*	Operators must set a clear internal policy on risk tolerance, having regard to the harm avoidance aims of COBS 19A and the operator's business model and resources. Curiously, there appears to be no express requirement for the internal risk policy to help inform the DD conducted on third parties as required by COBS 19A.2, but this should be consistent. Where the operator is involved in arranging / acquiring the investment: • there is no exemption to the investment DD even where the client is sophisticated, HNW or a professional client. It also applies

Proposal and Application	Key Obligations	Practical Implications / Recommendations / Observations
	to ensure no new / further such investments are allowed in the scheme.	where the investments are bought on advice from a FCA-authorised adviser who has passed the DD checks proposed under COBS 19A.2. • Initial DD must be conducted when an investment (or investment type) is first accepted and reviewed on an ongoing basis as necessary.
Core Investment DD Obligation *Completing core DD is sufficient to satisfy the operator's DD requirements for investments set out at COBS 19A.3.6 (3), unless the "operator is aware, or reasonably should be aware, of information relating to the relevant third party that is indicative or suggestive of a material risk to clients' individual pots", in which case additional DD is also required.*	For all proposed or held investments or types of investments, operators must take *"reasonable steps"* to verify that the investment is: • Not taxable property for the purposes of relevant UK tax rules; • An asset with a verifiable trail of ownership and documented origin, and to which good title has been, or can be, obtained; and • Capable of being reliably valued, both initially and on an ongoing basis. COBS 19A.3.6 (3) sets out the investments which only require core DD. They are, in essence, regulated investments which are secure and/or liquid.	From a practical perspective: • Operators should verify the classification of any non-UK fund against current FCA definitions as post-Brexit divergence means that some EU funds may no longer satisfy the UK definition of a regulated collective investment scheme. This also impacts standard asset definitions. • It appears that some non-standard assets may only require core DD. For example, longer than 30-day unbreakable term deposits held by a deposit-taking firm would appear to be a non-standard asset that only requires core DD. This means firms cannot automatically assume that this only applies to a subset of standard assets. • Operators will want to have a clear policy around valuations and what amounts to verifiable ownership.
Additional DD *Applies to all investments not set out in COBS 19A.3.6. Operators must determine what additional DD is appropriate having regard to the investment, its risk profile and the firm's regulatory obligations.*	Operators must undertake a *"reasonable and proportionate approach"* to satisfy themselves that the investment is genuine, credible and not associated with fraud, scams or unrealistic investment propositions. FCA examples include: • FCA/overseas warning list screening; • Adverse media checks on issuers, promoters and related parties;	The FCA's examples are non-exhaustive and should not be treated as a complete DD framework. Operators must determine, through their internal risk tolerance policy, what additional DD is required and whether this should be applied by investment, investment type and/or provider. The CP also specifically highlights the following assets as giving the FCA cause for concern: • Non-mass market investments (non-mainstream pooled investments; speculative illiquid securities);

Proposal and Application	Key Obligations	Practical Implications / Recommendations / Observations
	• FSCS (or equivalent) protection assessment; • Assessment of investment structure, business model and projected returns; • Whether there are structures with complex, unusual or opaque features which might indicate a higher risk of harm; • Assessment of investor rights and enforceability in applicable overseas jurisdictions; • Where the level or type of fees, commissions and charges may be an indicator of higher risk to clients e.g. because of conflicts; and • Identification of operational issues that may lead to concerns (e.g. payment or redemption difficulties, valuation or previous default).	• Restricted mass market investments (except LTAFs), including non-readily realisable securities; and • Direct investments in UK or overseas commercial property. Whilst there are no specific rules for these asset classes, operators will want to carefully consider the additional DD they undertake on these.
Adverse Findings	Where DD identifies an investment that should not be accepted (or continue to be accepted), the operator must take reasonable steps to prevent further investment, update any relevant investment parameters and communicate restrictions to relevant third parties. The operator must also take reasonable steps to mitigate potential harm to existing investors and meet the information needs of affected clients.	Operators should review their existing DD processes and forms against the new expectations set out in COBS 19A. This includes checking how decisions to accept or reject investments and third parties are made and recorded, implementing appropriate ongoing monitoring, and ensuring a clear escalation process is in place for circumstances where an asset or third party no longer meets requirements.

SIPP investments made by third parties without the Operator's involvement

COBS 19A.4 proposes distinct obligations on operators where third parties, without the operator's involvement, *"deal in, acquire or manage investments that are, or are proposed to be, held within the scheme in connection with self-investment options"*.

Investment parameters and oversight

Under the proposed framework, operators would be required to establish investment parameters governing the investments, or types of investment, that a third party may hold within the scheme. Investment parameters will be defined by reference to their internal risk policy and whether the investments would likely satisfy their own DD requirements if acquired directly.

The parameters need to be put in place before any investments are acquired by the relevant third party and kept under regular review and the operator must ensure they communicate any changes to relevant third parties.

Written Agreement Requirements

Written agreements with third parties to which COBS 19A.4 applies need to:

- specify the investments or types of investment that the third party is permitted (or prohibited) from acquiring within the scheme, in accordance with the operator's investment parameters (as above);
- require the third party to take all reasonable steps to remedy any breach of those investment parameters;
- set out any DD, compliance checks or other requirements that the third party must undertake so as to enable the operator to comply with its relevant obligations under COBS 19A.3.4R; and
- require the third party to provide sufficient information to support the operator's ongoing oversight and monitoring of compliance.

On this last point, the consultation paper goes further, stating that arrangements should specify the *"the information required, including the frequency and quality of the information the third party must provide"*. The FCA states that firms should be willing and able to terminate relationships where necessary information is not provided.

Operators would also be required to consider whether the agreement should include an indemnity in favour of the operator (or a successor operator) for losses suffered to the scheme as a result of, or in connection with, a breach of the agreement.

Compliance Checks

The proposed rules require operators to carry out periodic checks of assets managed by third parties to ensure that:

- all assets reflect the investment parameters set by the operator;
- the third party's obligation to take all reasonable steps to rectify any breach of the investment parameters can be given effect to; and
- any applicable capital requirements can be accurately calculated by the Operator, in accordance with IPRU-INV 5.9.

Although the FCA stops short of mandating a review cycle, the CP states that it expects these checks to be undertaken quarterly. It will be difficult for firms to conduct these less frequently without taking on regulatory risk.

Where a breach of the investment parameters is identified, operators would be required to take timely and appropriate action in light of their regulatory obligations, including the Consumer Duty, Principle 2 and the client's best interests rule. Particular care would be required where those investments pose high investment risk, high costs and charges or affect the operator's capital adequacy. Depending on the circumstances, appropriate action may include:

- restricting or terminating further dealings with the relevant third party;

- assessing whether the investment should continue to be held within the scheme, in light of exit options;
- escalating concerns to the operator's senior management; and
- considering, and taking, appropriate steps to meet the information needs of affected clients.

Practical Implication: The FCA's repeated emphasis on operators meeting the information needs of affected scheme members is significant. Operators cannot assume that responsibility for client communications rests solely with intermediaries and need to ensure that, where an issue arises , they are prepared, willing and able to communicate with affected clients directly. This will be a point for the written agreements as well as practical policies and procedures. It will also require operators to be proactive in considering client information needs.

Governance, monitoring and record keeping

Governance Framework

The FCA proposes that operators establish and maintain DD policies, procedures, controls and monitoring arrangements (the **"DD Framework"**) to support compliance with COBS 19A obligations. The DD Framework would need to be reviewed at least annually and more frequently where warranted by the nature of the operator's business, the investments held within the scheme and the risks to clients, or following a significant control failure. Any weaknesses or deficiencies identified would need to be addressed promptly (and notification to the FCA considered if sufficiently serious).

As part of creating the DD Framework, operators would be expected to establish appropriate internal benchmarks and indicators (which reflect their business model and risk tolerance) to measure the effectiveness of their DD processes and controls, and consider what level of training and governance oversight is necessary to ensure compliance.

Monitoring

In addition to reviewing the DD Framework, the FCA proposes a detailed management information framework to enable operators to assess the effectiveness of their DD arrangements, identify emerging risks and determine whether further remedial action is required. The consultation paper envisages, as a minimum, management information capturing:

- the percentage of total investments which are subject to additional DD, both as a share of the current value of investments held within the scheme in connection with self-investment options and as a share of the current value of investments held within each client's individual pot;
- for each investment / type of investment (as appropriate) subject to additional DD, the steps and outcomes of the operator's DD showing how the operator has satisfied itself that it has fulfilled its obligations; and
- the investments proposed to be held within the scheme that the operator has concluded should not be permitted, or has otherwise identified as acquisitions that are not permissible, together with the reasons for those determinations.

The FCA also proposes that this information is broken down by each relevant third party. This represents a significant level of granularity and may require significant work for operators to develop these operational capabilities.

The operator would also need to ensure management information is updated at least every six months (or more frequently where appropriate) and actively reviewed after each update to identify weaknesses, trends or concerns requiring further action. Where these are identified, and the breach is sufficiently significant, operators should consider if FCA notification is needed.

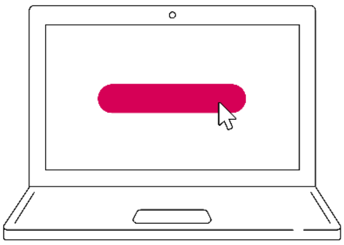
It is not immediately clear the frequency required for assessments required under COBS 19A.5.3. It is also unclear what amounts to updating the management information such that a review is triggered (and then over what information that review should be conducted and the scope of any review). For example, does updating any part of the management information trigger a review of all management information and/or an assessment? Is there a difference between reviewing the management information and conducting an assessment of the effectiveness of the policy and procedures?

We assume operators, over time, will develop automated and/or real time updates such that management information may be updated automatically very frequently. It would be counter-intuitive for this to trigger a review of management information. This is an area on which operators should seek further clarity from the FCA as part of the consultation.

Record Keeping

As part of complying with their SYSC 9 obligations, operators must keep sufficient records to enable the FCA to monitor or ascertain compliance by each firm with their COBS 19A obligations. These records should:

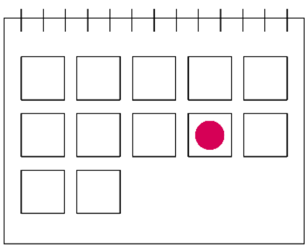
- document the operator's DD processes;
- the outcomes of DD exercises on relevant third parties and investments;
- the investment parameters for relevant third parties;
- written agreements with relevant third parties; and
- management information, including updates and revisions.



The records made in connection with the obligations in COBS 19A.5.3R, COBS 19A.5.6R and COBS 19A.5.7R must be retained indefinitely and made available for inspection by the FCA on request.

Implementation Period

The FCA proposes a 12-month implementation period, running from the date the instrument is made. For bespoke / full SIPP operators, this is likely to be a challenging timeframe involving significant cost and effort, particularly when reviewing all existing arrangements, creating and agreeing the written agreements, ensuring data is held to the required level of granularity and building the capacity to undertake periodic assessments using management information.

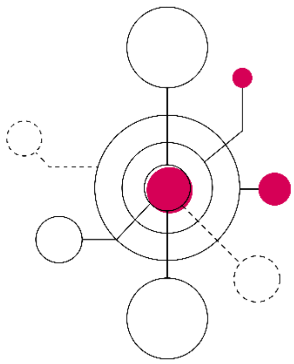


During the implementation period, operators would be expected to review existing third-party arrangements and make any changes necessary to align them with the proposed regime. Once the implementation period has ended, the new rules would apply to new investments to the scheme, further investments into existing assets and any new arrangements with relevant third parties.

The proposed rules will not apply retrospectively and investments already accepted into the scheme will remain subject to existing high-level obligations under Principle 2, COBS 2.1.1R and the Consumer Duty (where applicable). That said, there is a tendency to use hindsight when applying previous rules and so operators will want to consider addressing older investments where possible.

Conclusion

The changes being proposed may appear straightforward in principle, but, particularly for bespoke SIPP operators, they represent a significant enhancement on current practice. There will be substantial implementation cost and the proposals appear likely to constrain the breadth of investments and third parties with which operators engage (from a cost and practicality perspective, not simply from those who do not / cannot satisfy DD requirements).



Whilst the consultation period remains open, SIPP operators should consider responding, either individually or through a trade association, where they believe the proposed obligations require refinement or greater clarity. Operators should also begin assessing the operational, governance and contractual changes that may be required, as a 12-month implementation period will pass quickly.

Finally, and unrelated to this consultation paper, we note that satisfying the proposed DD requirements is not the end of the matter for operators. Even where an investment or third party passes DD, in light of Consumer Duty and other regulatory principles, firms will still need to consider to which clients it is appropriate for these arrangements/investments to be made available.

If any SIPP operator wants to discuss anything within this article or regulatory requirements on SIPP operators more generally, please contact the author.

Many thanks to Ellen Murphy for her contribution to this article.

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