The conduct of business and client assets rules

1. Introduction

1.1. Chapter overview

In this chapter we look at the conduct of business rules (COBS). These rules cover the need to categorise the client a firm is working with, communications with clients, the advisory and execution services of a firm and the protection of clients' assets.

This is a long and detailed chapter and it may be worth breaking up your study of this chapter in to manageable sections.

1.2. Learning outcomes

On completion of this module you will:

Client categorisation

- LO 3.5.1 - Explain the purpose of client categorisation
- LO 3.5.2 - Distinguish between a retail client, a professional client and an eligible counterparty (COBS 3.4, 3.5 & 3.6)
- LO 3.5.3 - Apply the rules relating to treating a client as an elective professional client (COBS 3.5.3)
- LO 3.5.4 - Apply the rules relating to treating a client as an elective eligible counterparty (COBS 3.6.4)
- LO 3.5.5 - Apply the rules relating to providing clients with a higher level of protection (COBS 3.7)

Communicating with clients

- LO 3.5.7 - Explain the purpose and scope of the financial promotions rules and the exemptions from them (COBS 4.1)
- LO 3.5.13 - Explain the rules relating to systems and controls in relation to approving and communicating financial promotions (COBS 4.10)
- LO 3.5.8 - Explain the fair, clear and not misleading rule (COBS 4.2)
- LO 3.5.9 - Explain the rules relating to communications with retail clients (COBS 4.5)
- LO 3.5.10 - Explain the rules relating to past, simulated past and future performance (COBS 4.6)
- LO 3.5.11 - Explain the rules relating to direct offer promotions (COBS 4.7)
- LO 3.5.12 - Explain the rules relating to cold calls and other promotions that are not in writing (COBS 4.8)
- LO 3.5.15 - Explain the rules relating to distance marketing communications (COBS 5.1)
- LO 3.5.14 - Explain the record keeping requirements relating to financial promotions (COBS 4.11)

Packaged Product Disclosures

- LO 3.5.33 - Explain the obligations relating to preparing product information (COBS 13.1 & COLL 4.7)
- LO 3.5.34 - Explain the rules relating to the form and content of a key features document and a key investor information document (COBS 13.2, 13.3, 14.2 & COLL 4.7)
- LO 3.5.35 - Explain the rules relating to cancellation rights (COBS 15)
- LO 3.5.36 - Distinguish between packaged products and retail investment products

Information about the firm

- LO 3.5.16 - Explain the rules relating to providing information about the firm and compensation information (COBS 6.1)

Client agreements

- LO 3.5.6 - Apply the rules relating to client agreements (COBS 8.1)

Suitability

- LO 3.5.19 - Explain the rules relating to assessing suitability (COBS 9.2)

Appropriateness

- LO 3.5.20 - Explain the rules relating to assessing appropriateness (COBS 10.2)
- LO 3.5.21 - Explain the rules relating to warning a client about the appropriateness of their instructions (COBS 10.3)
- LO 3.5.22 - Identify circumstances when assessing appropriateness is not required (COBS 10.4, 10.5 & 10.6)

Dealing and managing

- 3.5.29 - Explain the purpose of the principles and rules on Conflicts of Interest, including: identify, recording and disclosing conflicts of interest and managing them to ensure the fair treatment of clients (PRIN 2.1.1, Principle 8, SYSC 10.1.1 - 7 + 10.1.8 / 9 + 10.2)
- 3.5.30 - Explain the rules relating to investment research produced by a firm and disseminated to clients (COBS 12.2)
- 3.5.31 - Explain the rules relating to the publication and dissemination of non-independent research (COBS 12.3)
- 3.5.32 - Explain the disclosure requirements relating to the production and dissemination of research recommendations (COBS 12.4)
- 3.5.25 - Explain the rules relating to best execution (COBS 11.2)
- 3.5.26 - Explain the rules relating to client order handling (COBS 11.3)
- 3.5.27 - Explain the rules relating to the use of dealing commission (COBS 11.6)
- 3.5.28 - Explain the rules on personal account dealing (COBS 11.7)

Reporting information to clients

- 3.5.38 - Apply the rules relating to occasional reporting to clients (COBS 16.2)
- 3.5.39 - Apply the rules relating to periodic reporting to clients (COBS 16.3)
- 3.5.40 - Explain the rules relating to reporting on the progress of an authorised fund to unit holders (COLL 4.5)
- 3.5.37 - Apply the rules relating to record keeping for client orders and transactions (COBS 11.5)

Client assets

- 3.5.41 - Explain the concept of fiduciary duty
- 3.5.42 - Explain the application and purpose of the rules relating to custody of client assets held in connection with MiFID business (CASS 6.1)
- 3.5.43 - Explain the rules relating to the protection of clients' assets and having adequate organisational arrangements (CASS 6.2)
- 3.5.44 - Explain the rules relating to depositing assets with third parties (CASS 6.3)
- 3.5.45 - Explain the purpose of the rules relating to the use of clients' assets (CASS 6.4)
- 3.5.46 - Explain the rules relating to records, accounts and reconciliations of clients' assets (CASS 6.5)
- 3.5.47 - Explain the application and general purpose of the client money rules (CASS 7.2)
- 3.5.48 - Explain the rules relating to the segregation of client money (CASS 7.4)
- 3.5.49 - Explain the rules relating to records, accounts and reconciliations of clients' assets (CASS 7.6)
- 3.5.50 - Explain the rules relating to mandate accounts (CASS 8)

2. Contextual Points

2.1. The general application rule

The COBS rules apply to all authorised firms which carry on the following activities:

- Accepting deposits i.e. commercial banking
- Long-term insurance business in relation to life policies
- Designated investment business

The term 'designated investment business' covers fewer activities than the full range of 'regulated activities' (as defined in FSMA 2000 and discussed in Chapter 1). It does not include mortgages and home finance, general insurance (i.e. car and house insurance), or pure protection products (e.g. a life policy with a life of less than ten years and no surrender value).

You are not expected to know what activities are and are not designated investment business.

2.2. Appointed representatives

The COBS rules apply directly to a firm. They apply indirectly to the appointed representative of a firm.

An appointed representative is:

- A party to a contract with an authorised person (his/her principal) which permits or requires him to carry on business
- Someone for whose activities the authorised person has accepted responsibility in writing

An example of an appointed representative is a self-employed advisor who sells the firm's products.

Although the COBS do not apply directly to a firm's appointed representatives, a firm will always be **directly** responsible for the acts and omissions of its appointed representatives in carrying on business for which the firm has accepted responsibility.

2.3. MiFID business

Many of the rules distinguish between designated investment business and MiFID business.

MiFID business is discussed in Chapter 2 in detail. It is a much narrower range of activities than designated investment business. It can, however, be seen as a subsection of designated investment business.

In the context of the COBS rules it will be sufficient for you to know if the rule applies for all designated investment business or MiFID business.

2.4. Durable medium

The FCA often states that a firm must provide information in a durable form. It has a distinct definition of a durable form or medium.

A durable medium is any of the following:

- Paper

- Any instrument which enables the recipient to store information in an accessible way for future reference which allows the unchanged reproduction of information stored. Examples of this are:
  - Floppy disks
  - CD-ROMs
  - DVDs
  - The hard drive of the recipient's computer
- But **not** internet websites unless they fulfil the criteria in this definition

The firm should use an appropriate durable medium for the business carried out.

The durable medium should also be chosen by the recipient.

3. Client Categorisation

3.1. The purpose of client categorisation

Client categorisation is a vital process for the firm to perform, as only by categorising a client can a firm know which rules to apply.

There are three categories of client:

- Retail clients
- Professional clients
- Eligible counterparties

The formal definition of a client includes more than just existing customers of a firm. You may come across the following expressions:

- 'Consumer' – this refers to a natural person who is a retail client
- 'Customer' – this refers to retail clients and professional clients, but not eligible counterparties
- 'Client' – this refers to any or all of retail clients, professional clients, and eligible counterparties

Therefore, we can say that clients are customers (professional clients and retail clients) and eligible counterparties.

The following persons are defined as a client of a firm:

- A person to whom the firm provides a service or an ancillary service (in the case of MiFID business)
- A potential client
- In relation to the financial promotion rules, a person to whom a financial promotion is communicated by or on behalf of the firm
- A client of an appointed representative of the firm

3.2. General notifications to clients

A firm must notify a client of its categorisation (as a retail client, professional client or eligible counterparty) and, before providing any services, inform the client in a durable medium about any right the client has to request a different categorisation and about any limitations to the level of client protection.

Of the three categories, an eligible counterparty is not technically a client. You will see later in this section that eligible counterparties are the most knowledgeable and experienced parties in the markets, and when these parties conduct certain business with each other it becomes difficult to identify who is the firm and who is the client.

For this reason, the FCA creates the eligible counterparty category to show that we are not looking at a firm doing business for a client, but equals doing business with each other.

3.3. Retail clients

A retail client is a client who is not a professional client or an eligible counterparty. This will normally be individuals and small businesses.

3.4. Professional clients

A professional client is either a **per se** professional client or an **elective** professional client.

A per se professional client is automatically a professional client.

An elective professional client **chooses** to be a professional client.

Per se professional clients

This is the full list of per se professional clients.

1. Firstly, it is organisations required to be authorised or regulated to operate in the financial markets, including:
    - A credit institution
    - An investment firm
    - Any other authorised or regulated financial institution
    - An insurance company
    - An authorised CIS (or its management company)
    - A pension fund (or its management company)
    - A commodity or commodity derivatives dealer
    - A local (i.e. a self-employed trader on an open-outcry exchange)
    - Any other institutional investor
2. Next, in relation to MiFID business, an undertaking can be a 'per se' professional client if it meets **two** out of the **three** tests below:
    - Balance sheet total of €20m
    - Net turnover of €40m
    - Own funds of €2m
3. In relation to non-MiFID business the tests are different:
    - A company or limited liability partnership (LLP) with called up share capital of at least £5m; or
    - A company meeting **two** of the following **three** size requirements:
        - Balance sheet total of €12.5m
        - Net turnover of €25m
        - Average number of employees: 250
4. A national or regional government (such as a local authority), a public body that manages public debt, a central bank, an international or supranational institution (such as the World Bank or the IMF) or another similar international organisation

5. An institutional investor whose main activity is to invest in financial instruments (MiFID business) or designated investments (non-MiFID business)

Elective professional clients

Elective professional clients are those that are not automatically professional clients. These clients can choose to be treated as such. Normally a client would choose to do this because they would be charged lower fees by the firm.

A firm may treat a client as an elective professional client if it complies with:

- The 'qualitative test'; and
- The procedures; and
- The 'quantitative test'

Qualitative test

The firm must check that the client is able to be a professional client.

In particular the 'qualitative test' requires the firm to undertake an adequate assessment of the expertise, experience and knowledge of the client. This must give reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making its own investment decisions and understands the risks involved.

The procedures

The procedures require that:

- The client must state in writing that it wishes to be treated as a professional client (either generally or in respect of a particular service or transaction or type of transaction or product)
- The firm must give the client a clear written warning of the protections and investor compensation rights the client may lose
- The client must state in writing, in a separate document from the contract, that it is aware of the consequences of losing such protections

In summary, this is a **three-way** process. The client states it wants this treatment, the firm provides details of the consequences and the client confirms it understands this.

Quantitative test

The 'quantitative test' only applies to MiFID business.

This requires that at least **two** of the following criteria are satisfied:

- The client has carried out transactions, of significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters
- The size of the client's financial instrument portfolio (defined as including cash deposits and financial instruments) exceeds €500,000
- The client has relevant work experience. In particular, the client works, or has worked, in the financial sector for at least one year in a professional position. This position must require knowledge of the transactions or services to be undertaken

Other points to note about electing up

The following further points about elective professional clients should be noted:

- If the client is an entity, the qualitative test should be performed in relation to the person authorised to carry out transactions on its behalf
- An elective professional client should not be pressured to possess market knowledge and experience comparable to a per se professional client

What if a client no longer meets the test?

There should be systematic reviews of professional clients to ensure that they still meet the requirements. If the firm becomes aware that an elective professional client no longer fulfils the relevant initial conditions for elective status, the firm may need to recategorise the client as a retail client. If the client is recategorised, it must be notified of this.

3.5. Eligible counterparties

An eligible counterparty is either a per se eligible counterparty or an elective eligible counterparty.

In relation to MiFID business, a client can only be an eligible counterparty in relation to eligible counterparty business.

Eligible counterparty business

Eligible counterparty business comprises services and activities carried on with or for an eligible counterparty in the areas of dealing on the accounts, execution of orders on behalf of clients or reception and transmission of orders (or any ancillary services directly related to these).

Essentially eligible counterparty business can be summarised as acting as principal broker or transmitting to a third party with an eligible counterparty.

Per se eligible counterparties

The following are per se eligible counterparties (this includes entities from inside and outside the EEA):

- An investment firm
- A credit institution
- An insurance company
- A UCITS scheme (or its management company)
- A pension fund (or its management company)
- Another authorised or regulated EEA financial institution
- Certain own account dealers in commodities or commodity derivatives
- A national government (including a body dealing with public debt)
- A central bank
- A supranational organisation, such as the IMF or World Bank

Elective eligible counterparties

The status of being an elective eligible counterparty is only available to an undertaking (not to an individual).

An elective eligible counterparty may be:

- Any per se professional client (except an institutional investor)
- Any elective professional client who asks for this status (but only in respect of services or transactions for which it could be treated as a professional client)

In relation to MiFID business, the firm must obtain express confirmation from the client that it agrees to be treated as an eligible counterparty (this confirmation may be either in the form of a general agreement or in respect of each individual transaction). So a client can choose to be a professional client for one type of business and choose to be an eligible counterparty for another business type.

Who cannot be an elective eligible counterparty?

As an eligible counterparty is provided with less protection, two types of client cannot be eligible counterparties. These are:

- Individuals
- Other institutional investors (e.g. SPVs)

3.6. Providing clients with a higher level of protection

A per se eligible counterparty may be treated as a professional client or a retail client; and a per se professional client may be treated as a retail client. This may be done either on the firm's own initiative or at the request of the client.

Where a per se eligible counterparty asks to be subject to conduct of business protections, the firm must treat that client as a professional client (unless the client expressly requests treatment as a retail client).

In relation to the MiFID business, if a per se eligible counterparty or a per se professional client requests treatment as a retail client, it must enter into a written agreement with the firm specifying the scope of the recategorisation (i.e. what services or transactions it applies to).

Recategorising a client as a retail client under these provisions does not necessarily mean that it will become an eligible complainant or can use the Financial Ombudsman Service (FOS).

3.7. Policies and procedures

Policies and procedures

A firm must have in place appropriate written internal policies and procedures to categorise its clients.

4. Communicating with clients, including financial promotions

4.1. Financial promotions: sources of regulation

The financial promotion rules are complicated and involve two separate, but linked, sources of regulation.

These are:

- S21 FSMA 2000
- Conduct of business rules

Each of these is explained in more detail below.

4.2. S21 FSMA 2000

A financial promotion is an invitation or inducement to engage in investment.

S21 FSMA 2000 imposes a restriction on the communication of financial promotions by unauthorised persons. A person **must not** communicate a financial promotion unless:

- An authorised person; or
- The content of the financial promotion is approved by an authorised person

This rule amplifies:

- Principle 6 (customers' interests) which requires a firm to pay due regard to the interests of its customers and treat them fairly; and
- Principle 7 (communications with clients) which requires a firm to pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading

Breach of S21 carries a penalty of two years in jail and an unlimited fine.

4.3. Approving financial promotions

Before a firm approves a financial promotion for communication by an unauthorised person, it must confirm that the financial promotion complies with the financial promotion rules and it must withdraw its approval if at any time it becomes aware that this is no longer the case, and notify any person known to be relying on its approval.

A firm must not approve a financial promotion to be made in the course of a personal visit, telephone conversation or any other interactive dialogue.

Relying on another firm's confirmation of compliance

A firm may communicate a financial promotion which has been:

- Produced by another person

- Approved (as regards confirmation of compliance with the financial promotion rules) by another firm

So long as it takes reasonable care to establish that the confirmation of compliance was validly given and has not been withdrawn.

4.4. Types of communication

Communication media

There are no restrictions on the types of media that can be used for financial promotions. Examples of means of communication include:

- Printed advertising
- Radio and television broadcasts
- Personal visit
- Telephone call
- Email
- Internet
- Electronic media such as digital and interactive television

Financial promotions: examples

Financial promotions can therefore take the following forms:

- Product brochures
- General advertising in magazines, newspapers, radio and television programmes and websites
- Mailshots: post, fax, email and other media
- Telemarketing activities such as telephone calls from call centres
- Presentations to groups of individuals
- Tip sheets

Non-written communications

A **non-written** financial promotion is a financial promotion made during the course of:

- A personal visit
- A telephone conversation
- Other interactive dialogue

Contact can be initiated by the client, in which case it is described as '**solicited**'; or by the firm, in which case it is '**unsolicited**' (an unsolicited real-time communication is, of course, simply an elaborate regulatory description of a cold call).

Written promotions

Promotions other than non-written are termed as written. These are traditional advertisements such as letters, emails, websites and newspapers.

With **written** promotions there is no personal interaction between the firm and the client.

The meaning of 'made', 'directed at' and 'recipient'

A communication being **made** to another person is a reference to a communication being addressed, whether verbally or in writing, to a **particular** person or persons (e.g. where it is contained in a telephone call or letter).

A communication being **directed** at persons is a reference to a communication being addressed to persons **generally** (e.g. where it is contained in a television broadcast or website).

A **recipient** of a communication is the person to whom the communication is made or (in the case of a non-real-time financial promotion which is directed at persons generally) any person who reads or hears the communication.

4.5. Financial promotion conduct of business rules

In general, the conduct of business rules apply when a firm:

- Communicates with a client in the UK
- Communicates a financial promotion (or approves one for communication) to a person in the UK

The conduct of business rules also apply to the communication of a cold call to a person outside the UK (unless the cold call is made from a place outside the UK for the purposes of non-UK business).

4.6. Fair, clear and not misleading communications

The fair, clear and not misleading rule

A firm must ensure that a communication by the firm or a business or a financial promotion communicated or approved by the firm is fair, clear and not misleading.

The rule applies to a firm that communicates to a client in relation to designated investment business.

This rule does **not** apply to financial promotions communicated by the firm that:

- Are excluded communications
- Are non-retail communications

An example of an excluded communication is a one-off financial promotion that is not a cold call (i.e. a promotion communicated only to one recipient, or only to one group of recipients, in relation to a product or service that has been tailored to the particular circumstances).

A non-retail communication is one made only to eligible counterparties or professional clients.

4.7. Other general rules

A financial promotion addressed to a client must be clearly identifiable as a financial promotion. This does not apply in the case of 'image advertising', which is a communication consisting only of the name

and logo of the firm, a contact point and the types of regulated activities (and associated fees or commissions) provided by the firm.

Any reference in advertising to an investor compensation scheme must be limited to a factual reference to the scheme.

4.8. Communication with retail clients

Information contained in a communication or financial promotion that is addressed to, or likely to be received by, a retail client must:

- Include the name of the firm
- Be accurate and give fair balance between relevant investment benefits
- Be sufficient for, and comprehensible by, the average likely recipient
- Avoid disguising, diminishing or obscuring important items, statements or warnings

The FCA makes particular reference to identifying capital at risk products.

Where comparative information is provided, the comparison must be meaningful and presented in a fair and balanced way.

Any reference to a particular tax treatment must prominently state that this depends on individual circumstances and may be subject to change in the future.

4.9. Past, simulated past and future performance

Past performance

Where information communicated by a firm contains an indication of past performance (e.g. of an investment or a financial index), the following rules apply:

- That indication must not be the most prominent feature of the communication
- Performance information must cover at least the last five years (or the whole available period, if less), and must be based on complete 12-month periods
- The reference period and source information must be stated
- There must be a prominent warning that the figures refer to the past and that past performance is not a reliable indicator of future results
- The currency must be clearly stated (if different from that of the EEA state where the retail client is resident), together with a warning about the effect of currency fluctuations
- If the indication is based on gross performance, the effect of commissions, fees or charges must be disclosed

Simulated past performance

When information contains an indication of simulated past performance, this must:

- Relate to an investment or a financial index and be based on the actual past performance of an investment or financial index which is the same as, or underlies, the investment concerned
- Comply with the same rules as apply to indication of past performance (above)

Future performance

Where information contains an indication of future performance, this must:

- Not be based on, or refer to, simulated past performance
- Be based on reasonable assumptions supported by objective data
- Disclose the effect of commissions, fees or charges (if based on gross performance)
- Contain a prominent warning that such forecasts are not a reliable indicator of future performance

4.10. Direct offer financial promotions

Direct offer financial promotions are financial promotions that enable a person to enter into an agreement with a firm by responding in a specified manner (such as completing a tear-off or coupon in a newspaper or magazine).

If it is likely to be received by a retail client, a direct offer financial promotion must contain:

- Such as the information set out in the disclosure of information rules (in COBS 6) as is relevant to the product or service being promoted (this covers information about the firm, its services, the safeguarding of investments, cost and charges)
- If it does not relate to MiFID business, additional appropriate information enabling the client to understand the nature and risks of the investment and to take investment decisions on an informed basis

Exemptions

- For MiFID business:
  - Image advertising
- For non-MiFID business:
  - Excluded communications under the FPO
  - Deposits (**not** ISA or CTF deposits)
  - Pure protections contracts

4.11. Promotions that are not in writing

When a firm initiates a non-written financial promotion communicated to a particular person outside the firm's premises, the person communicating must:

- Only do so at an appropriate time of day
- Identify him/herself and the firm he/she represents at the outset and make clear the purpose of the communication
- Clarify that the client can continue with or terminate the communication at any time
- Give a contact point to any client with whom he/she arranges an appointment

4.12. Cold calls and other promotions that are not in writing

Restriction on cold calling

A firm may only make a cold call in one of the following three circumstances:

- The recipient of the cold call has an established existing client relationship with the firm and envisages receiving cold calls
- The cold call relates to a generally marketable product (which is not a higher volatility fund)
- The cold call relates to activities where the only investments involved are readily realisable securities (other than warrants) and generally marketplace non-geared packaged products

'Packaged products' are defined as:

- A life policy
- A unit in a regulated collective investment scheme
- A stakeholder pension scheme
- An interest in an investment trust savings scheme
- A personal pension scheme

'Higher volatility funds' are defined as regulated CIS in which the price of units is likely to fluctuate significantly because of investments by the fund in warrants or derivatives or because of long-term borrowing.

'Readily realisable securities' are defined as:

- A government or public security
- Any other security which is listed and regularly traded on an EEA exchange or regularly traded on RIE

4.13. Distance Marketing Directive (DMD)

The DMD aims to ensure that for consumers (defined below) there is a consistent cross-border approach to providing both information about a product and cancellation rights when business is conducted either in writing, electronically or over the telephone (distance contracts).

This information includes:

- Information about the firm
- Information about the financial service
- Information about the contract
- Information about redress

This information must be provided in a clear and comprehensible manner.

5. Packaged Product Disclosures

5.1. Product disclosure: purpose

Under Principle 7 (communications with clients) firms must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

A firm must prepare a key features document for each packaged product in good time before that document has to be provided.

Packaged products

Packaged products are any of the following products:

- A life policy
- A unit in a regulated collective investment scheme
- A stakeholder pension scheme
- An interest in an investment trust savings scheme
- A personal pension scheme

Key features disclosures are also required for:

- Cash deposit ISAs
- Cash deposit Child Trust Funds (CTFs)

5.2. Key features document (KFD)

Key features must be provided in a ‘durable medium’ and must also:

- Be produced and presented to at least the same quality and standard as the sales or marketing material used to promote the relevant product
- Display the firm's brand at least as prominently as any other
- Include the 'key facts' logo in a prominent position at the top of the document
- Include the following statement in a prominent position:
  - 'The Financial Conduct Authority is the independent financial services regulator. It requires us, [provider name], to give you this important information to help you to decide whether our [product name] is right for you. You should read this document carefully so that you understand what you are buying, and then keep it safe for future reference.'

Contents of a KFD

A KFD must:

- Include enough information about the nature and complexity of the product
- Explain:
  - The arrangements for handling complaints about the product

- That compensation might be available from the FSCS
- Details covering the right to cancel or withdraw exists
- (For a CTF) that stakeholder CTFs, cash-deposit CTFs and share CTFs are available and which type the firm is offering
- (For a personal pension scheme) clearly and prominently, that stakeholder pension schemes are generally available and might meet the client's needs as well as the scheme on offer

5.3. UCITS IV: CIS Key Investor Information Document (KIID)

One of the key provisions of the new UCITS IV directive is the introduction of Key Investor Information Documents (KIIDs) for UCITS-compliant collective investment schemes. These replaced the simplified prospectus documents of UCITS III, which was felt to have several deficiencies. The KIID is aimed at retail investors, and should be couched in language that retail investors will find simple to understand. The KIID must be clear, fair and not misleading, and should include only information that a retail investor would need to make an informed investment decision. The following items are necessary in the KIID:

- Identification of the scheme
- A short description of the scheme's investment objectives and investment policy
- Past performance information, or if relevant, performance scenarios
- Costs and associated charges
- The risk/reward profile of the scheme, including risk warnings where appropriate

5.4. The client's right to cancel

Application

This rule applies to:

- Most providers of retail financial products that are based on deposits or designated investments
- Firms that enter into distance contracts with consumers that relate to accepting deposits or designated investment business

A consumer has a right to cancel any of the following contracts with a firm:

- Life policies and pension schemes within 30 calendar days
- Any other packaged product within 14 calendar days

Start of cancellation period

The cancellation period begins on the latter of:

- The day of the conclusion of the contract, except in respect of contracts relating to life policies where the time limit will begin from the time when the consumer is informed that the contract has been concluded
- From the day on which the consumer receives the contractual terms and conditions and any other pre-contractual information

Disclosing a right to cancel or withdraw

The firm must disclose in a durable medium to the consumer in good time before or, if that is not possible, immediately after the consumer is bound by a contract that attracts a right to cancel or withdraw.

5.5. Retail investment products

The description ‘retail investment products’ is a new classification that has been introduced by the FCA and purposely broadens the definition for the old packaged products. A summary of the differences is below:

Table 3. Retail investment products

Packaged product	Retail investment product
A life policy	Life policies (including investment bonds)
A unit in regulated collective investment schemes	Units in regulated and unregulated collective investment schemes
An interest in an investment trust savings scheme	An interest in an investment trust savings scheme
A stakeholder pension	A stakeholder pension/group stakeholder pension
A personal pension	A personal pension scheme (including self-invested personal pensions)/group personal pension scheme
	Share in an investment trust
	Structured capital at risk products
	Any other product that has been packaged in order to change the features of the product

5.6. Inducements

Rule on inducements

In relation to designated investment business or, in the case of MiFID business, another ancillary service, a firm must not pay to, or accept from, a person other than the client (or someone acting on the client's behalf) any fee or commission (or provide or receive any non-monetary benefit) unless the following conditions are satisfied:

- The fee, commission or benefit does not impair compliance with the firm's duty to act in the best interests of the client
- The firm clearly discloses to the client the existence, nature and amount of the fee, commission or benefit before providing the service, but this disclosure requirement is subject to the following qualifications:
  - In the case of business other than MiFID business, disclosure is only required if the business includes giving a personal recommendation in relation to a packaged product
  - In the case of business other than MiFID business, disclosure is not required if the benefit falls within the table of reasonable non-monetary benefits (see below)
  - Disclosure is not required where a firm is giving basic advice on a stakeholder product
- In the case of MiFID business, the fee, commission or benefit is designed to enhance the quality of the service to the client

Proper fees which are necessary for the provision of the business or ancillary services (such as custody costs, settlement and exchange fees, legal fees, etc.) are permissible since, by their nature, they cannot give rise to conflicts with the firm's duties to act honestly, fairly and professionally in accordance with the best interest of its clients.

Reasonable non-monetary benefits

In relation to the sale of packaged products, the FCA has drawn up a table of reasonable non-monetary benefits (referred to above) which may usually be given by a product provider (such as a life assurance company or a unit trust operator) to a firm (such as an IFA). The table includes the following items:

- Gifts, hospitality and promotional prizes of a reasonable value
- Assistance in promoting packaged products
- Generic product literature (i.e. letterheads, leaflets, forms and envelopes)

Record keeping: inducements

Where a firm gives a fee, commission or benefit to another firm it must make a record and keep it for at least five years from the date on which the fee etc. was given.

6. Information about the firm, its services and remuneration

6.1. Information disclosure before providing services

General requirements

A firm must provide appropriate information in a comprehensive form to a client about:

- The firm and its services
- Designated investments and proposed investment strategies (including appropriate guidance and warnings about the risks associated with these investments and strategies)
- Execution venues
- Costs and associated charges

The client must be able to understand the nature and risks of the service and of the specific type of investment being offered.

The information may be provided in a standardised format.

This rule applies in relation to MiFID business.

Where the rule applies it relates to a derivative, a warrant or stock lending activity for a retail client. The requirement to provide information about designated investments and proposed investment strategies also applies to business other than MiFID business.

6.2. Further information to be provided

A firm must provide a retail client and (in the case of MiFID business) any client with prescribed information. This includes:

- Information about the firm and its services:
  - Name and address of the firm and appropriate contact details
  - Method and language of communication
  - Statement that the firm is authorised (and the name of its competent authority i.e. regulator)
  - Whether the firm is acting through an appointed representative (or a tied agent)
  - Details of occasional and periodical reporting
  - Conflicts of interest policy
- Information about safeguarding of designated investments and client money
- Information about costs and associated charges

This information must be provided in a durable medium, whether before any service is provided or (if this is impossible, as where an agreement is concluded by distance communication) immediately after starting to provide the service.

A firm carrying on MiFID business must also make available information to enable a client to identify any relevant investor compensation scheme.

Most of the information about the firm, its services, the investments, fees and charges will be provided in an initial disclosure document (IDD) to retail clients before engaging in business.

6.3. Information by a firm that manages investments

If a firm proposes to manage investments for a retail client, the following information must be provided so as to enable the client to assess the firm's performance:

- The method and frequency of valuation of the client portfolio
- Details of any third party who may provide the discretionary management
- Information of any benchmark against which the performance of the client portfolio will be compared
- The types of designated investments that may be included in the client portfolio and the types of transactions that may be carried out in those designated investments
- The management objectives, the level of risk and any specific constraints on the management of the portfolio

6.4. Safeguarding of client's designated investments and money

A firm that holds designated investments or client money for a retail client must provide that client with the following information:

- If held by a third party
  - The responsibility of the firm for any acts or omissions by the third party
  - The consequences for the client of the insolvency of the third party
- If the designated investments belonging are not segregated from those of the third party or of the firm, notify the retail client and warn of the resulting risks
- If the accounts of the client will be subject to the law of jurisdiction other than that of an EEA state and an indication that the rights of the client may differ accordingly
- If applicable, about the existence and terms of any security interest or lien which the firm has or may have over the client's designated investments or client money
- A summary description of the steps which the firm takes to ensure the protection of the designated investments belonging to the client or client money it holds

Before entering into stock lending of a retail client's assets, a firm has to provide the clients, in a durable medium, which contains clear, full and accurate information on the obligations and responsibilities of the firm with respect to the use of those designated investments.

6.5. Information about the cost and associated charges

A firm must provide a retail client with information on costs and associated charges including, if applicable:

- The total price to be paid by the client in connection with the designated investment or the designated investment business or ancillary service

- If paid in a foreign currency, the applicable currency conversion rates and costs
- Notice of the possibility that other costs, including taxes, may arise for the client
- Arrangements for payment

6.6. Compensation information

A firm carrying on MiFID business must inform their client of any relevant compensation scheme available to the client, for example the Financial Services Compensation Scheme.

This information must include the amount and scope of cover available, and any rules affecting the claims process. These rules may include any formalities or conditions that the client may face. This information must be made available in a durable medium in the official language (or languages) of the EEA state.

6.7. Timing and medium

Timing

The firm must make these disclosures in good time before the provision of services.

The disclosure of information can be made immediately after starting to provide services if by request of the client the agreement was concluded through distance marketing.

Clients must be informed of any material changes by durable medium in good time.

Medium

The information should be provided:

- In a durable medium; or
- On the website, where the website conditions have been fulfilled

7. Client agreements

The conduct of business rules describe a client agreement as a written basic agreement between the firm and the client, which sets out the essential rights and obligations of the firm and the client.

A client agreement is required when a firm carries on designated investment business for retail clients and (in relation to MiFID business) for professional clients. It must be provided in a durable medium.

A client agreement is not required where a firm is effecting contracts of insurance in relation to a life policy issued, or to be issued, by the firm in principal.

The firm must provide the client with the terms of agreement before the earlier of:

- The client agreement becoming binding
- The provision of any services

At the same time, the firm must provide the client with information about itself and its services, as required by COBS 6 (see previous section), including information on communications, conflicts of interest and authorised status.

(This rule on timing is relaxed in the case of an agreement concluded by distance communication).

8. Suitability

8.1. Application

The rules on suitability apply to a firm which makes a personal recommendation in a designated investment or which manages investments.

In the case of non-MiFID business the rules only apply if:

- The client is a retail client
- The firm is managing the assets of an occupational pension scheme, stakeholder pension scheme or personal pension scheme

8.2. Assessing suitability: the obligations

A firm must take reasonable steps to ensure that a personal recommendation, or a decision to trade, is suitable for its client.

In order to assess suitability, the firm must obtain appropriate information about the client's:

- Investment knowledge and experience
- Financial situation
- Investment objectives

The firm must obtain this information from the client, and it must be sufficient to give the firm a reasonable basis for believing that a proposed transaction:

- Meets the client’s investment objectives
- Is such that the client is able financially to bear any related investment risks consistent with the client's investment objectives
- Is such that the client has the necessary experience and knowledge to understand those risks

The firm is entitled to rely on the information provided by the client (unless it is aware that the information is manifestly out of date, inaccurate or incomplete).

Note (importantly) that if the firm does **not** obtain the necessary information to assess the suitability, it must **not** make a personal recommendation to the client or take a decision to trade for the client.

In the case of MiFID business conducted with professional clients, the firm is entitled to assume:

- In the case of all professional clients, that they have the necessary experience and knowledge to understand the risks; and
- In the case of per se professional clients, that they are able financially to bear any related investment risks

Churning (which is overtrading in securities) and switching (which is overtrading in packaged products) were both formerly prohibited under the conduct of business rules. The motivation behind the practice was to generate commission for the firms, rather than act in the best interests of the client. A reference to churning and switching is still retained in the present rules as guidance in identifying practices that would not pass the suitability report.

8.3. Suitability reports

Transactions requiring a suitability report

Some personal recommendations made by a firm to a retail client must be supported by a suitability report. This is where the recommendation relates to:

- Transactions in a regulated CIS, an interest in an investment trust savings scheme or an investment trust where the shares are to be held in a PEP or ISA
- The purchase, sale or surrender of, or conversion or conciliation of rights under or suspension of contributions to, a personal pension scheme or a stakeholders' pension scheme
- An election to make income withdrawals or to purchase a short-term annuity
- Entering into a pension transfer or pension opt-out

A suitability report is also required to support a personal recommendation made by a firm to any client in relation to a life policy.

There are some circumstances where the obligation to provide a suitability report does not apply. These include:

- A recommendation about a regulated CIS where the firm is acting as investment manager for a retail client
- The client is habitually resident outside the EEA and is not in the UK at that time

Context of suitability report

The suitability report must, at least:

- Specify the client's demands and needs
- Explain why the firm believes that the recommended transaction is suitable for the client
- Explain any possible disadvantages of the transaction for the client

Timing of suitability report

The firm must provide the suitability report to the client:

- In the case of a life policy – before the contract is concluded (unless immediate cover is necessary)
- In the case of a personal pension scheme or stakeholder pension scheme – no later than 14 days after the contract is concluded (this is tied in with the timing of cancellation rights, which are not included in your syllabus)
- In any other case – at, or as soon as possible after, the effecting of the transaction

9. Appropriateness (for non-advised services)

9.1. Application

The rules on appropriateness apply to a firm which provides investment services in the course of MiFID business other than making a personal recommendation and managing investments. This will typically be non-advised services.

9.2. Assessing appropriateness: the obligations

When providing a firm must ask the client to provide information about his/her relevant knowledge and experience to enable the firm to assess whether the service or product envisaged is appropriate for the client.

The firm must determine whether the client has the necessary experience and knowledge to understand the risks involved in relation to the product or service (in this context, the firm may assume that a professional client has the necessary experience and knowledge to understand the risks involved in relation to the products or services for which he/she is classified as a professional client).

As with the rule on suitability, the firm is entitled to rely on the information provided by the client (unless it is aware that the information is manifestly out of date, inaccurate or incomplete).

9.3. Warning the client

A firm is required to give a warning to the client in two circumstances (these warnings may be provided in a standardised format):

- Where the firm considers, on the basis of the information received, that the product or service is **not** appropriate for the client, it must warn the client of that
- Where the client does not provide information to enable the firm to assess appropriateness (or where the client provides insufficient information regarding his/her knowledge and experience), the firm must warn the client that it is **unable to determine** whether the product or service is appropriate for him/her

If a client asks the firm to go ahead with a transaction despite the warning given by the firm, it is up to the firm to decide it is in the interest of the client to do so in the circumstances.

9.4. Assessing appropriateness: when it need not be done

A firm is not required to ask its client to provide information or to assess appropriateness if the service only consists of execution and/or reception and transmission of orders and it relates to a non-complex financial instrument.

Non-complex financial instruments are:

- Shares traded on a regulated (or equivalent) market
- Money market instruments, binds or other forms of securitised debt (excluding those embedding a derivative)
- Units in a UCITS scheme
- Other non-complex financial instruments

Non-complex financial instruments must satisfy the following criteria:

- They are not derivatives (or similar products)
- There are frequent opportunities to trade them at independently determined, publicly available prices
- They do not involve a potential liability that exceeds their cost
- There is publicly available information on their characteristics that is likely to be readily understood by the average retail client for the purpose of making an investment decision

10. Dealing and managing

10.1. Application

The rules in this section on dealing and managing apply to all firms except:

- The rules on personal account dealing apply to any designated investment business activities carried on from an establishment in the UK
- The rules on the use of dealing commission apply only to a firm that acts as an investment manager

10.2. Conflicts of interest

Application

The rules on conflicts of interest apply where a common platform firm is carrying on regulated (or ancillary) activities or providing ancillary services (when these constitute MiFID business) for a client. The status of the client (retail client, professional client or eligible counterparty) is irrelevant for this purpose.

A firm must take all reasonable steps to identify conflicts of interest between:

- Itself (including its managers, employees and appointed representatives) and a client of a firm
- One client of the firm and another client
- Different departments within the same firm

Management or disclosure of conflicts of interest

Principle for Business 8 states a firm must have effective arrangements to manage conflicts of interest so as to prevent them giving rise to a material risk of damage to a client's interests. Under SYSC10, this includes having a written policy.

Where these arrangements might not be sufficient to prevent the risk of damage to a particular client's interests, the firm, before undertaking business for that client, must disclose relevant details of the conflict of interest in a durable medium (i.e. in writing, email, or equivalent form).

10.3. Investment research

Investment research produced by a firm to be disseminated to clients

When a firm produces investment research for dissemination to its clients or to the public, the financial analysts involved in the production of investment research (and other relevant persons) may have interests which conflict with the interests of the persons to whom the investment research is disseminated.

Accordingly, the firm must ensure the implementation of all the measures for managing conflicts of interest in SYSC 10 (conflicts of interest).

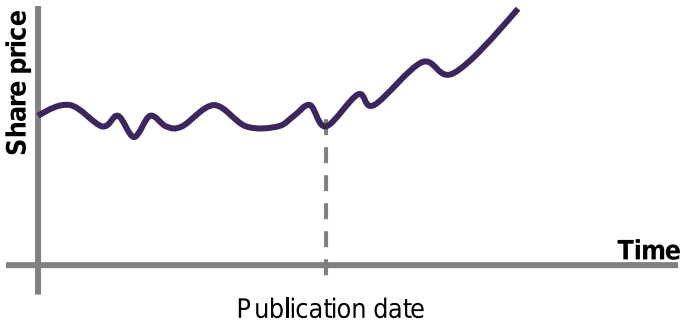
In particular, a firm must ensure that:

- If a financial analyst or other relevant person has advance knowledge of investment research which is not yet available to the firm's clients or the public, he/she must not undertake personal transactions or trade on behalf of another person (including the firm) until the recipients of the investment research have had a reasonable opportunity to act on it (there are exceptions for dealing as a market maker

in good faith and in the ordinary course of business and for dealing to execute an unsolicited client order).

- A financial analyst or other relevant person must not undertake personal transactions in financial instruments to which the investment research relates contrary to current recommendations (except in exceptional circumstances and with prior approval from the firm's legal or compliance function)
- The firm, a financial analyst or other relevant person must not accept inducements from those with a material interest in the subject matter
- The firm, a financial analyst or other relevant person must not promise issuers favourable research coverage
- Issuers, relevant persons (other than financial analysts) and any other persons must not, before the dissemination of the investor research, be permitted to review a draft of it for the purpose of verifying the accuracy of factual statements made in it, or for any other purpose other than verifying compliance with the firm's legal obligations, if the draft includes a recommendation such as a target price

A firm is not obliged to comply with all these requirements where it is simply disseminating investment research produced by another person, where the producer is itself subject to these requirements and is independent of the firm.



An FSA firm must not knowingly deal for its own account until the clients for whom the publication was intended have had a reasonable time to react to it unless:

- The firm is a market maker dealing in the normal course of business
- Unsolicited customer orders

Publication and dissemination of non-independent research

Investment research is research which is presented as being objective and independent. Non-independent research is a research recommendation which does not constitute investment research (and which cannot, therefore, be presented as being objective and independent).

Non-independent research must:

- Be clearly identified as a marketing communication
- Contain a clear and prominent statement that:
  - It has not been prepared in accordance with rules designed to promote the independence of investment research
  - It is not subject to any prohibition on dealing ahead of the dissemination of investment research

The financial promotion rules apply to non-independent research as though it were a marketing communication.

Research recommendation: required disclosure

The Market Abuse Directive, which was implemented in the UK in July 2005, introduced new requirements relating to the disclosures that must be made when a firm prepares or disseminates research recommendations. These rules apply to all firms that prepare or disseminate research recommendations.

These disclosure obligations do not require a firm to breach effective Chinese Wall arrangements that are already in place.

A firm must take reasonable care:

- To ensure that any research recommendation it publishes is fairly presented
- To disclose any interests or conflicts of interest it may have in any investments covered by the research

The research document must disclose clearly and prominently the identity of the person responsible for its production and, in particular:

- The name and job title of the individual who prepared the research recommendation
- The name of the firm (and the fact it is authorised or regulated by the FCA)

10.4. Best execution

Best execution obligation and execution factors

When executing an order for a client, a firm must take all reasonable steps to obtain the best possible result for its client, taking into account the execution factors.

The execution factors are defined as the 'price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of an order'.

Best execution criteria

A firm must take into account the following criteria for determining the relative importance of the execution factors:

- The characteristics of the client, including the categorisation of the client as retail or professional
- The characteristics of the client order
- The characteristics of financial instruments that are the subject of that order

- The characteristics of the execution venues to which the order can be dissected

For the purposes of this rule, execution venue means a regulated market, a multilateral trading facility (MTF), or a market maker or other liquidity provider.

Role of price

In the case of a retail client, the best possible result must be determined in terms of the total consideration, representing the price of the financial instrument and the costs related to execution.

The costs related to execution must include all expenses incurred by the client which are directly related to the execution of the order, including execution venue fees, clearing and settlement fees and any other fees paid to third parties involved in the execution of the order.

Competing execution venues

In the case of a retail client, where there are two or more competing execution venues, the firm, in assessing and comparing the results that could be achieved for the client on each execution venue, must take its own commissions and costs for executing the order into account.

The firm must not structure or charge its commissions in such a way as to discriminate unfairly between execution venues.

The competing execution venues that will be assessed by the firm are the ones that are listed in the firm's order execution policy (see below).

10.5. Order execution policy

In order to satisfy its obligation to obtain the best possible result for its clients, a firm is required to establish and operate an order execution policy. This policy must include, for each class of financial instrument, information about the different execution venues that the firm will use to execute client orders and the factors affecting the choice of execution venue.

Information about the order execution policy

A firm must provide appropriate information to its clients about its order execution policy. In the case of a retail client, the firm must provide the following details about its execution policy before executing any transaction:

- An account of the relative importance the firm assigns to the execution factors
- A list of the main execution venues used by the firm
- A clear and prominent warning that any specific instructions from the client may prevent the firm from taking the steps that it would otherwise have taken under its order execution policy to obtain the best possible result for the client

(This warning is needed because, whenever a client gives a specific instruction about an order, the firm is required to execute the order in accordance with that specific instruction; and this overrides any requirement the firm might otherwise have, e.g. to compare between execution venues, and satisfies the firm's obligations under the best execution rule).

Where the order execution policy provides for the possibility that client orders may be executed outside a regulated market or an MTF, the firm must receive consent from its clients about this possibility. This could be general consent or with regard to individual transactions.

Order execution policy: other requirements

- A firm must obtain the prior consent of its clients to its order execution policy
- A firm must obtain the prior express consent of its clients before executing their orders outside a regulated market or an MTF. This may be by means of a general agreement or transaction-by-transaction
- A firm must regularly monitor the effectiveness of its order execution arrangements and execution policy, and it must review them annually
- A firm must be able to demonstrate to its clients, at their request, that it has executed their orders in accordance with its order execution policy

Duty of portfolio managers to act in clients' best interests

The obligation to act in the best interest of its clients is extended to a portfolio manager when it places an order with another entity for execution on behalf of its client.

A portfolio manager is defined as a firm which manages portfolios in accordance with mandates given by clients on a discretionary client-by-client basis (i.e. a discretionary investment manager providing a personalised service).

The same obligation applies to any firm which receives and transmits orders to another entity for execution on behalf of a client.

10.6. Client order handling

General principles

A firm must implement procedures which provide for the prompt, fair and expeditious execution of client orders. In general, otherwise comparable orders should be executed in chronological order of receipt by the firm.

Orders executed on behalf of clients must:

- Be promptly recorded and allocated
- Otherwise comparable orders must be carried out sequentially and promptly

If the characteristics of the order or prevailing market conditions make this impracticable, or:

- The interest of the client requires otherwise
- If there is any material difficulty in properly carrying out an order promptly

A retail client must be immediately notified of the case.

Aggregation and allocation of orders

A firm is not permitted to aggregate a client order with an own account transaction or another client order unless the following conditions are met:

- It must be unlikely that the aggregation will work overall to the disadvantage of any client whose order is to be aggregated
- It must disclose to each client that the effect of aggregation may work to their disadvantage in a particular order

- The firm must have in place an order allocation policy, providing in precise terms for the allocation of aggregated orders

If a firm aggregates a client order with an own account transaction and the aggregated order is partially executed, it must allocate the related trades to the client in priority to the firm. However, if the firm is able to demonstrate reasonable grounds that, without the combination, it would not have been able to carry out the order on such advantageous terms, or at all, it may allocate the own account transaction proportionally, on accordance with its order allocation.

Client limit orders

Where a client places a limit order in respect of shares traded in a regulated market and the order is not immediately executed under prevailing market conditions, then, unless the client expressly instructs otherwise, the firm must make the order public with a view to having it executed as soon as possible. The firm can do this by transmitting the order to a regulated market or MTF that operates an order book trading system. This is part of the pre-trade transparency rules.

This obligation to make public a limit order will not apply to a limit order that is large in scale compared with normal market size (large in scale for this purpose is a size greater than approximately 10% of the share's average daily trading volume).

10.7. Use of dealing commission

Background

For many years fund management firms and broking firms were permitted to do business with one another on the basis of 'soft commission' (or 'softing') agreements.

These allowed the fund manager to pass on to its own underlying customers the commission or other charges it incurred for outing transactions through the broking firm, and in return for these charges the fund manager received from the broker valuable goods or services in addition to the execution of its customers' orders.

In other words, it could be argued that the underlying customers were paying not only for the execution of the transactions done on their behalf, but also for certain additional benefits received by the fund manager.

Soft commission business was always regarded as controversial, and the rules that permitted it were eventually removed from the regulator's Handbook in 2006.

Use of dealing commission to purchase goods or services

There are controls on an investment manager which:

- Executes its customer orders through a broker
- Passes on the broker's charges (whether commission or otherwise) to its customers
- In return for these charges, receives goods or services in addition to the execution of its customer orders

These controls require the investment manager who does business in this way to be reasonably satisfied that the goods or services it receives from the broker:

- Are related to the execution of trades on behalf of its underlying customers **or** comprise the provision of research

- Will reasonably assist that investment manager in the provision of its services to its customers and are not likely to impair compliance with its duty to act in the best interest of its customers

(In this context, a 'customer' is a client of the firm who is not an eligible counterparty).

The most common service provided by brokers that would comply with this rule is investment research.

Non-permitted goods and services

Examples of goods and services that the FCA does **not** regard as meeting the relevant requirements include:

- Portfolio valuation or performance measurement
- Computer hardware
- Dedicated telephone lines
- Seminar fees
- Subscriptions for publications
- Travel, accommodation and entertainment costs
- Office administrative computer hardware
- Membership fees to professional associations
- Purchase or rental of office equipment
- Employees' salaries
- Direct money payments
- Publicly available information
- Custody services
- Post-trade analytics (relating to trade execution condition only)
- Price feeds or unanalysed historic price data relating to provision of research condition only

Prior and periodic disclosure

An investment manager who uses dealing commission to purchase goods or services in accordance with these rules must make prior and periodic disclosure to its customers. This disclosure must include details of the goods or services that relate to trade execution and, wherever appropriate, separately identify the details of the goods or services that relate to the provision of research.

Prior disclosure should be made to a customer before conducting business. Periodic disclosure to the firm’s customers should be made at least annually. A record of each periodic disclosure must be made and retained by the firm for at least five years.

10.8. Personal account dealing

A firm must have in place arrangements to prevent inappropriate dealing by any relevant person (this includes directors, partners, managers, employees and appointed representatives). Personal account

dealing rules follow the home state regulations for firms, i.e. it is not dependent on where the client is based.

This covers personal account transactions which:

- Are prohibited under the Market Abuse Directive
- Involve the misuse or improper disclosure of confidential information relating to clients or their transactions
- Conflict or are likely to conflict with the firm's obligations to a customer under the regulatory system

This prohibition extends also to a relevant person:

- Advising or procuring another person to enter into such a transaction
- Disclosing it in such a way that it could be used to the same effect

This rule also covers:

- Financial analysts who have advance knowledge of the content of investment research
- Relevant persons who misuse information relating to pending client orders of which they have advance knowledge

The firm's arrangements on personal account dealing must ensure that:

- Each relevant person is aware of the restrictions on personal transactions (and of the firm's arrangements in this area)
- The firm is informed promptly of all personal transactions
- A record is kept of all personal transactions notified to the firm (including any authorisation or prohibition in connection with such a transaction)

The rule on personal account dealing does not apply to personal transactions in:

- A discretionary account managed independently of the relevant person
- Rights or shares in a UCITS scheme
- Life policies

11. Reporting information to clients

11.1. General client reporting requirement

In relation to MiFID business a firm must ensure that a client receives adequate reports in the services provided to it by the firm (including, where applicable, the costs associated with the transactions and services).

11.2. Occasional reporting (confirmations)

Timing of dispatch

When a firm has carried out an order on behalf of a client, it must promptly provide the client, in a durable medium, with the essential information concerning the execution of the order.

In the case of a retail client, the firm's notice must include the relevant trade confirmation information (see below). This must be sent as soon as possible and no later than the next business day after execution (or, where the confirmation is received by the firm from a third party, no later than the next business day after receipt).

Trade confirmation information

Essential information includes, for example:

- Maturity, delivery or expiry date of derivatives
- For options, the last exercise date, expiry style and strike price
- When closing out an option, essential details of the open contract closed out, and of the profit or loss arising for the client as a result of closing the contract out
- Date of exercising an option, and whether exercise creates a purchase or sale for the client
- The strike price of the option, and the total consideration due to or from the client (where applicable)

11.3. Periodic reporting

Provision of periodic statement

If a firm is managing investments on behalf of a client, it must provide the client with a periodic statement in a durable medium (unless such a statement is provided by another person).

In the case of a retail client, the periodic statement must include the relevant periodic information (see below).

Timing of periodic statement

In the case of a retail client, the periodic statement must be provided once every six months (or, if the retail client so requests, every three months).

If the retail client elects to receive information about executed transactions on a transaction-by-transaction basis (and there are no transactions in derivatives during the period):

- The periodic statement must be provided once every 12 months

- The firm must comply with the occasional reporting rules (confirmations) for each transaction executed

If a firm manages investments for retail clients or the portfolio includes contingent liability investments/leveraged portfolio, the firm must report within one business day any losses beyond a pre-determined limit.

11.4. Reporting information about authorised funds to unitholders

Introduction

Although not part of the FCA's conduct of business rules (COBS), it is worth highlighting the requirements for an authorised collective investment scheme to report to unitholders on a regular basis. These rules are contained in the collective investment schemes sourcebook (COLL).

Overview

The authorised fund manager must provide the unitholders with regular and relevant information about the progress of the authorised fund by:

- Preparing and sending a short report to all unitholders half-yearly; and
- Preparing, annually, and making a long report available to unitholders on request.

The short report

The short report must contain:

- The name of the scheme or sub-fund;
- Its stated investment objectives and the strategy used to achieve this;
- A brief assessment of the risk profile;
- For a UCITS scheme, the most up-to-date synthetic risk and reward indicator and any changes to that figure during the period;
- The name and address of the authorised fund manager;
- A review of the investment activities and investment performance during the period;
- A performance record to contextualise the results of the investment activities;
- Sufficient information on where the portfolio is invested and how this has changed over the period;
- Any other significant information on the activities of the scheme and the results of those activities; and
- A statement that the latest long report is available on request.

The long report

The long report contains the full accounts and reports prepared by the fund manager, the depository and the auditor.

12. Client Assets

12.1. Fiduciary duty

The main objective of the rules relating to client assets (including client money) is designed to ensure that client assets are protected either in the case of an authorised firm becoming insolvent or from the misuse of client assets by a firm or its employees.

Remember that under the EEA passporting regime a passported firm applies its **home** state's rules on client assets. Therefore, a UK firm passported to Germany would still be required to follow the FCA rules on client assets.

12.2. Holding of clients' assets

Purpose

- To restrict co-mingling of clients' and firms' assets
- To minimise the risk of client assets being used without the consent or against the wishes of the clients

Application

The custody rules apply to a firm when it is safeguarding and administering investments.

The regulated activity of safeguarding and administering investments covers:

- Safeguarding and administration of assets by the firm
- Arranging the safeguarding and administration of assets by a third party

The definition of safe custody investments includes:

- Safe custody investments - designated investments that a firm receives or holds
- Custody assets - any other assets the firm holds in the same portfolio as a designated investment on behalf of the client

Exemptions

The custody rules **do not** apply to:

- Deposits made with a Banking Consolidation Directive (BCD) credit institution
- Coins held by the firm for the value of their metal
- Investment business passported into the UK
- Designated investments held on behalf of an affiliated company (**unless** they are held for a client, or the affiliated business is an arm's length client)
- A firm acting as the operator of an alternative investment fund (AIF) or UCITS scheme

Delivery vs. payment (DvP) transactions

The firm will sometimes have possession of client investments ***temporarily***, e.g. if investments are being bought from or sold to a client.

The custody rules **do not** apply to DvP transactions, provided:

- Delivery of the investment is due within **one business day** of payment
- Delivery or payment by the firm will occur within **three business days** of the client making delivery or payment

Registration of investments held

A firm must effect appropriate registration or recording of legal title to a financial instrument in the name of:

- The client (or the trustee firm). Unless the client is an authorised person acting on behalf of its client, in which case it may be registered in the name of the client of that authorised person.
- A nominee company which is controlled by:
  - The firm
  - An affiliated company
  - A recognised investment exchange or a designated investment exchange
  - A third party with whom financial instruments are deposited
- Any other third party if:
  - Law outside the UK requires it and the firm has taken reasonable steps to determine that it is in the client's best interests
  - The firm has notified the client in writing
- The firm if:
  - Law outside the UK requires it and the firm has taken reasonable steps to determine that it is in the client's best interest
  - The firm has notified the client if a professional client, or obtained prior written consent if a retail client

12.3. Depositing assets and arranging for assets to be deposited with third parties

Third parties can be used to hold assets belonging to the firm or a client of the firm. The firm must:

- Exercise all due skill, care and diligence in the selection of the third party
- Ensure the assets belonging to the firm are separately recorded from those held by the third party
- Conduct period reviews of the third party considering:
  - The expertise and market reputation of the third party; and

  - Any legal requirements or market practices that could adversely affect the clients' rights

- Make and keep up to date records of the grounds on which the third party was selected and/or retained

Clearly the third party should operate in a country that is subject to regulation that is significantly similar to the UK client asset rules. However, this may not be the case if:

- The assets are of a nature that require them to be deposited in such a country; or
- A professional client has requested in writing that they are helped in that country.

Use of clients' assets

A firm must not enter into arrangements for securities-financing transactions (such as stock lending or repurchase agreements), unless:

- The client has given express prior consent to the use of the financial instruments on specified terms; and
- The use of that client's financial instruments is restricted to the specified terms to which the client consents.

12.4. Reconciliations

Introduction

The firm will have three different sets of records relating to the safe custody business it provides:

- A record of the safe custody investments that it is accountable for, but does **not** hold in its possession
- A record of safe custody investments that it **does** physically hold itself
- A record of **all** the safe custody investments held on a client-by-client basis

These must each be reconciled according to different time frames and methods as set out below.

If a firm has not or cannot comply with these requirements it must notify the FCA in writing without delay.

Record of investments not held by the firm

A firm must, as often as is necessary, perform a reconciliation of its record of safe custody investments for which it is accountable but which it does not physically hold, with statements obtained from custodians.

Record of investments held by the firm

These must be reconciled as often as is necessary against a **count** of the safe custody investments in its possession.

The counting of the investments held may be by either one of two methods:

- By way of a **total count**, which means that the investments are counted and reconciled as at the **same date**
- By way of the **rolling stock** method. This entails counting the investments over a period of time. This may only be used subject to the FCA's approval

A firm that uses an alternative reconciliation method must first send a written confirmation to the FCA from the firm's auditor that the firm has in place systems and controls which are adequate to enable it to use the method effectively.

Record of all investments held

This must be reconciled against the location of each investment. Here the firm must reconcile **what** investments they are holding for the client with **where** they are held.

Shortfalls

Any discrepancies thrown up by the reconciliation process must be corrected promptly and any shortfalls made up for.

12.5. Client money rules

Application

When a firm holds money which belongs to someone else then it is client money.

The rules apply where the firm is holding client money in relation to **designated investment business**.

Not client money: due and payable to the firm

Money is not client money when it becomes properly due and payable to the firm for its own account.

For fees and commissions payable by customers, 'due and payable' means:

- They have been accurately calculated on a basis previously disclosed to the client by the firm
- Five business days have elapsed since a statement showing fees and commissions has been despatched to the client, and the firm has taken reasonable steps to ensure that the client does not question them
- The precise amount of the fees or commissions has been agreed by the client, or has been determined by a court, arbitrator or arbiter

Other circumstances where the money becomes due and payable are when the firm sells securities as principal to the client or buys them as agent on behalf of the client. When the firm subsequently receives the money it is entitled to keep it for its own account.

When a firm has entered into an arrangement under which commission is rebated to a client, those rebates should be treated as client money as soon as the firm has completed its obligations.

Finally, where a firm sells assets held as security against client obligations, the amount of the liability belongs to the firm but any **excess** must be either returned to the client or held as client money.

Not client money: discharge of fiduciary duty

Money is not client money when the firm has discharged its responsibilities to segregate client money and holds it separately. Examples include when money is paid to:

- The client or their representative
- A third party on behalf of the client (e.g. payment to a clearing house to cover a margin call)
- A bank account of the client

- The firm where it is an excess in the client bank account (e.g. records show there is more in the account than is attributable to the client)

When a firm draws a cheque or other payable order to discharge its fiduciary duty, it must continue to treat the sum concerned as client money until the cheque or order is presented and paid by the bank.

Interest

A firm must pay retail clients all interest earned on client money, **unless** it notifies them in writing of:

- Whether or not interest is to be paid on client money
- If so, on what terms and at what frequency

Any interest due to a client must be treated as client money.

Segregation of client money

Client funds should be **segregated** from those of the firm by the use of client money bank accounts.

The FCA generally requires a firm to place client money in a client bank account with an 'approved bank'. An approved bank can be a central bank, a BCD credit institution, a bank authorised in its respective country or a qualifying money market fund.

A BCD credit institution is one that complies with the Banking Consolidation Directive.

A qualifying money market fund is a CIS authorised under UCITS or their local competent authority.

Firms must create trusts over client money bank accounts by an exchange of trust letters with the bank(s) holding client money. This prevents liquidators setting off client assets against the debts of the firm in an insolvency situation.

If a firm leaves some of its own money in a client money account, this will be referred to as a 'pollution of trust'. A liquidator will be able to seize **all** the money held in the client account for the general creditors of a bank.

Client money requirement

Every business day, firms are required to ensure that they have enough funds in client accounts to cover the client money requirement, i.e. physical cash held must equal the total of balances on client money accounts.

Reconciliations

A firm must reconcile its records of client balances to bank statements from approved banks as often as is necessary. The firm must complete the reconciliation of client money within 10 business days of the date to which the reconciliation relates.

This is done by comparing the balance on each client bank account against the statement or confirmation issued by the bank holding the accounts. The firm must also compare the balance (currency by currency) on each client transaction account against the statement or confirmation. This reconciliation applies to all approved collateral held by the firm.

If a discrepancy exists, firms must identify the reason and correct the discrepancy **as soon as possible**. Unresolved shortfalls in client funds need to be met out of the firm's resources until the discrepancy is resolved.

If a firm cannot comply with the reconciliation rules it must notify the FCA as soon as possible.

13. Record keeping requirement

13.1. Conduct of Business Sourcebook

In the Conduct of Business Sourcebook (COBS) the record keeping requirement is summarised below:

Table 4. Record keeping requirement

Type of business	Record keeping requirement
Pension transfers, opt outs or FSVC	Indefinitely
Life policy or pension scheme	5 years
MiFID or equivalent third country business	5 years
Any other case (e.g. other non-MiFID business)	3 years

The exception to this is where a financial promotion relates to pensions or life policies. For this document records must be kept for six years.

13.2. Client Assets Sourcebook

In the Client Assets Sourcebook (CASS) all record for CASS 6 and CASS 7 are kept for five years.

14. The Conduct of Business and Client Assets rules: summary

14.1. Key concepts

Contextual points

- These are not syllabus driven, but are useful to introduce some concept from the chapter

Client categorisation

- LO 3.5.1 - The purpose of client categorisation
- LO 3.5.2 - A retail client, a professional client and an eligible counterparty (COBS 3.4, 3.5 & 3.6)
- LO 3.5.3 - The rules relating to treating a client as an elective professional client (COBS 3.5.3)
- LO 3.5.4 - The rules relating to treating a client as an elective eligible counterparty (COBS 3.6.4)
- LO 3.5.5 - The rules relating to providing clients with a higher level of protection (COBS 3.7)

Communicating with clients

- LO 3.5.7 - The purpose and scope of the financial promotions rules and the exemptions from them (COBS 4.1)
- LO 3.5.13 - The rules relating to systems and controls in relation to approving and communicating financial promotions (COBS 4.10)
- LO 3.5.8 - The fair, clear and not misleading rule (COBS 4.2)
- LO 3.5.9 - The rules relating to communications with retail clients (COBS 4.5)
- LO 3.5.10 - The rules relating to past, simulated past and future performance (COBS 4.6)
- LO 3.5.11 - The rules relating to direct offer promotions (COBS 4.7)
- LO 3.5.12 - The rules relating to cold calls and other promotions that are not in writing (COBS 4.8)
- LO 3.5.15 - The rules relating to distance marketing communications (COBS 5.1)
- LO 3.5.14 - The record keeping requirements relating to financial promotions (COBS 4.11)

Packaged Product Disclosures

- LO 3.5.33 - The obligations relating to preparing product information (COBS 13.1 & COLL 4.7)
- LO 3.5.34 - The rules relating to the form and content of a key features document and a key investor information document (COBS 13.2, 13.3, 14.2 & COLL 4.7)
- LO 3.5.35 - The rules relating to cancellation rights (COBS 15)
- LO 3.5.36 - Packaged products and retail investment products

Information about the firm

- LO 3.5.16 - The rules relating to providing information about the firm and compensation information (COBS 6.1)

Client agreements

- LO 3.5.6 - The rules relating to client agreements (COBS 8.1)

Suitability

- LO 3.5.19 - The rules relating to assessing suitability (COBS 9.2)

Appropriateness

- LO 3.5.20 - The rules relating to assessing appropriateness (COBS 10.2)
- LO 3.5.21 - The rules relating to warning a client about the appropriateness of their instructions (COBS 10.3)
- LO 3.5.22 - Circumstances when assessing appropriateness is not required (COBS 10.4, 10.5 & 10.6)

Dealing and managing

- LO 3.5.29 - The purpose of the principles and rules on Conflicts of Interest, including: identify, recording and disclosing conflicts of interest and managing them to ensure the fair treatment of clients (PRIN 2.1.1, Principle 8, SYSC 10.1.1 - 7 + 10.1.8 / 9 + 10.2)
- LO 3.5.30 - Explain the rules relating to investment research produced by a firm and disseminated to clients (COBS 12.2)
- LO 3.5.31 - The rules relating to the publication and dissemination of non-independent research (COBS 12.3)
- LO 3.5.32 - The disclosure requirements relating to the production and dissemination of research recommendations (COBS 12.4)
- LO 3.5.25 - The rules relating to best execution (COBS 11.2)
- LO 3.5.26 - The rules relating to client order handling (COBS 11.3)
- LO 3.5.27 - The rules relating to the use of dealing commission (COBS 11.6)
- LO 3.5.28 - The rules on personal account dealing (COBS 11.7)

Reporting information to clients

- LO 3.5.38 - The rules relating to occasional reporting to clients (COBS 16.2)
- LO 3.5.39 - The rules relating to periodic reporting to clients (COBS 16.3)
- LO 3.5.40 - Explain the rules relating to reporting on the progress of an authorised fund to unitholders (COLL 4.5)
- LO 3.5.37 - The rules relating to record keeping for client orders and transactions (COBS 11.5)

Client assets

- LO 3.5.41 - The concept of fiduciary duty

- LO 3.5.42 - The application and purpose of the rules relating to custody of client assets held in connection with MiFID business (CASS 6.1)
- LO 3.5.43 - The rules relating to the protection of clients' assets and having adequate organisational arrangements (CASS 6.2)
- LO 3.5.44 - The rules relating to depositing assets with third parties (CASS 6.3)
- LO 3.5.45 - The purpose of the rules relating to the use of clients' assets (CASS 6.4)
- LO 3.5.46 - The rules relating to records, accounts and reconciliations of clients' assets (CASS 6.5)
- LO 3.5.47 - The application and general purpose of the client money rules (CASS 7.2)
- LO 3.5.48 - The rules relating to the segregation of client money (CASS 7.4)
- LO 3.5.49 - The rules relating to records, accounts and reconciliations of clients' assets (CASS 7.6)
- LO 3.5.50 - The rules relating to mandate accounts (CASS 8)

Now you have finished this chapter you should attempt the chapter questions.