



**DEADLINE: 31<sup>st</sup> MARCH 2007**

## **Treating Customers Fairly within Institutional Firms**

### **1. INTRODUCTION**

Treating Customers Fairly (TCF) is an FSA initiative that is aimed at ensuring that firms operate their businesses in a manner that ensures that their customers' best interests are taken care of. Whilst the initiative has been in a continuous stage of development and consultation over the past two years, the FSA has now indicated that it expects to see evidence of serious action. The FSA has set a deadline of 31<sup>st</sup> March 2007 for regulated firms to have developed and embedded TCF into their systems and behaviours.

It has often been assumed (wrongly) that TCF applies to retail firms only. (The FSA classifies firms broadly into retail and non-retail firms.) However, many firms carrying out discretionary management services or operating collective investment schemes may also interact directly with retail customers. Additionally whilst it is clear that the implications of TCF will be greater for firms dealing with retail customers, the FSA has made it abundantly clear that TCF applies to all firms.

TCF does not involve following a specific set of rules or regulations and there is no specific definition. There are however common concepts in relation to TCF that apply whatever the size or nature of the business. These relate to the way in which business is done and are central to the firms' culture.

TCF is something that all firms should strive to ensure is properly embedded into the culture of the whole organisation. Such culture is crucial to ensure that the requirements are properly met. Initially, the TCF initiative was mainly focused on the retail customer. However, in light of the Market in Financial Instruments Directive (MiFID) and the Transparency Directive (TD), TCF is now expected to have greater relevance to the institutional customer.

### **2. MANAGEMENT OF TREATING CUSTOMERS FAIRLY**

#### **2.1 Culture, Senior Management and the approach to TCF**

A culture of TCF should be evident in all parts of a firm's business from Senior Management down. Embedding TCF in Senior management Systems and Controls (SYSC) means a regulated firm will be seen to be applying the concept in a demonstrable manner. This will also show a proactive approach in adhering to the Conduct of Business (COB) Rules in the FSA Handbook.

Under the TD and MiFID, there will be further requirements relating to transparent information, conflicts of interest, suitability, fair / best execution and allocation for all customers regardless of institutional or retail status.

In developing a TCF regime throughout an organisation Senior Management should take full ownership and responsibility to ensure that:

- TCF is applied throughout the business in a manner that is appropriate for both the nature of the business and the customers; and
- TCF is firmly embedded in the firm's culture.

In developing the regime, and planning what action may be necessary, Senior Management will need to ensure that they follow the steps set out below.

### **2.1.1 Consider what TCF means for the firm and how it applies to the business and its' customers**

The impact of TCF will vary according to the size and structure of the business, the number and frequency of customers it deals with and the type of business being carried out. Before a TCF policy can be implemented, it is necessary to define the application of TCF to the particular firm. Senior Management should ensure that:

- they have taken full responsibility and ownership for TCF;
- they are fully committed to, and understand, TCF within their business environment, and given their particular customer base;
- they have formed a view on the interpretation and application of TCF in relation to their business;
- sufficiently senior personnel have been appointed to manage TCF within the organisation;
- a strategy has been agreed and developed; and
- they retain oversight of the delivery of TCF.

The firm should specifically ensure that due regard is paid to the customer-related provisions of MiFID and the TD. These forthcoming pieces of EU legislation will have a significant impact on specific TCF requirements for the institutional firm. Some of the major changes are summarised below:

#### **2.1.1a Conflicts of Interest**

Conflicts between the regulated firm and its' customers will need to be managed and recorded to avoid any breaches where the regulated firm, whilst trading on their own book and for their customers, do not, under any circumstances, put the customer at a disadvantage. This provision already exists in COB.

#### **2.1.1b Suitability**

A regulated firm will now need to conduct a suitability test on all customers. For the institutional customer, this will involve asking a series of questions to confirm that the customer fits the profile of an institutional client and the recording of this on the customer record. The documents (Terms and Conditions or Subscription) must make clear the service provided. In addition the firm must make a detailed note on each suitability assessment it makes and record it. This should be undertaken with each transaction if the customer is inexperienced in relation to the product.

In assessing suitability of a customer the firm must take into consideration:

- Knowledge and experience in the investment field relevant to the investment proposed or type of service;
- Financial situation;
- Investment Objectives; and
- The customers risk appetite.

#### **2.1.1c Best Execution**

Where a client provides specific execution instructions to a firm, clearly these instructions should be followed. In other circumstances, however, Article 21 of MiFID provides that factors such as price, costs, speed, size, nature or any other consideration relevant to the execution of the order, can be taken into account. Each of these factors may have an impact when a firm is seeking to obtain the "best execution" for their clients.

Article 44 of the implementing directive takes this a stage further by specifying that a set of further criteria must be taken into account: client characteristics and categorisation; type of order; type of instrument; and type of venue. "Venue", in this case, means the execution venue, which includes:

- A regulated market;
- A Multilateral Trading Facility (MTF);
- A systematic internaliser (defined as a firm which regularly deals on its own account by executing client orders outside a regulated market or MTF) or a market maker or other liquidity provider, or;
- An entity that performs a similar function in a third country.

#### 2.1.1d Pricing

The level two provisions concerning best execution do not require an investment firm to include in its execution policy all available execution venues (recital 66 of the implementing directive). The provisions, however, do require the firm to select the execution venues which enable it to obtain the best possible result for client orders.

As far as retail investors are concerned, however, the directive reinforces the notion that total consideration is the prevailing factor. The directive emphasises, however, that other factors may be given precedence over the immediate price and costs consideration, insofar as they are instrumental in delivering the best possible result in terms of the total consideration to the retail client (recital 67). Such factors could include: speed, likelihood of execution and settlement, the size and nature of the order, market impact and any other implicit transaction costs. The practical effect that this concession may have remains to be seen.

#### 2.1.1e Fee structuring

The factors to be considered, particularly when dealing with a client, include the concept of the total consideration — meaning the price of the investment itself, plus the total execution-related costs, including exchange fees and clearing and settlement fees which are paid by the client.

If more than one venue is being considered, the firm's own commissions and costs for executing the trade must be factored in as well. This means that firms may have to show the difference in cost between trades carried out internally for which they charge a spread, and a trade performed on exchange for which a commission is charged.

Given that a firm's own remuneration must be taken into account in determining best execution for clients, one might presume that firms should have to compare each other's commission structures. This is, however, not the case. The directive explicitly provides, at recital 71, that firms are not required to compare results which would be achieved on the basis of their own execution policy, commissions and fees with any other investment firm.

While such mandated transparency is to be welcomed, firms must not use the inclusion of their own fees in the calculation as a means of structuring their commissions in order to discriminate between venues. In other words, If Firm A wishes to use Venue B and wants to send its business in that direction, it could not, on the face of it, be justified as providing best execution if it amends its commission structure with regard to that venue in order to apparently justify its choice. Recital 73 makes this crystal clear. It provides that this sort of discrimination would be an issue if a firm charged a different commission or spread to clients for execution on different venues, and that difference did not reflect any actual difference in the cost to the firm of executing on those venues.

Another ploy which the European Commission is keen to subvert is that of firms declining to include particular execution venues on the basis of the cost to the firm of using them. Recital 72 provides that the parts of the directive which require that the costs of execution should include an investment firm's own commissions (or fees charged to the client for the provision of an investment service) should not apply for the purpose of determining which venues must be included in the firm's execution policy. This should deter firms from failing to verify their execution policy once they have chosen one or two execution venues, and failing to consider other trading platforms on the grounds of the expenditures needed to use them.

## 2.2 Treating Customers Fairly

Having looked at the requirement for Senior Management involvement, and the structured process for assessing applicability, we must now look at what is meant by Treating Customers Fairly and where specific risk areas lie.

### Common Concepts applicable to TCF

The core concepts that apply to TCF are ensuring that:

- there is clarity of the offer;
- promises are delivered;
- an acceptable resolution is found when things go wrong;
- the customer is not taken advantage of for any reason; and
- services and / or products sold are suitable for the needs of the customer.

### Risks to TCF

Risks to TCF arise at many stages of the life-cycle of a service and / or product sale, in the remuneration and reward systems applied for staff, in the firm's management information and in Senior Management failures.

These risks are assessed below. In accordance with the management requirements detailed above the involvement of Senior Management in the assessment of these risks and the planning of remedial action where risks are considered to need addressing is necessary.

#### 2.2.1 Service and Product life-cycle

Several areas should be looked at to consider whether issues arise within the service and / or product life-cycle that may compromise the delivery of TCF by the firm.

Service and / or product design should ensure that:

- services and / or products are suitable for the intended target audience;
- customers are given sufficient information in a suitable form to enable them to understand the service and / or product; and
- adequate monitoring of the service and / or product sale is undertaken.

Promotions should:

- be clear, fair and not misleading;
- target an appropriate customer base;
- be understandable; and
- ensure that all claims it makes are met in the service and / or product.

Sales advice – it should be ensured that those giving such advice should:

- have sufficient expertise;
- provide clear and fair explanations; and
- not be influenced by their incentives and remuneration structure.

After sales processes should ensure that:

- adequate monitoring is undertaken; and
- obligations are honoured.

Complaints procedures should be:

- properly conducted;
- easy to follow;
- consistent in their decisions; and
- ensure that root causes are addressed.

### 2.2.2 Culture and Rewards

Firms are urged to review the remuneration and rewards structure of their staff because of the risk that the system may encourage the unfair treatment of customers – e.g. by the use of high pressure sales or the sale of unsuitable services and / or products. TCF should also be used as a performance measure. In addition, firms should look at their training and ensure that all staff are fully aware of their TCF responsibilities.

### 2.2.3 Management Information

A significant risk to TCF is a failure in the management information upon which the firm's TCF strategy is developed. Risks here include the failure to:

- identify all the information requirements to enable Senior Management to assess the risks;
- distribute the information to all relevant personnel; and
- act on the management information.

### 2.2.4 Senior Management responsibility

The failure of Senior Management to:

- take sufficient responsibility;
- understand the strategy;
- assess the manner in which a firm meets its obligations; or
- track progress or implement remedial action where progress is not being made,

These factors present a risk to TCF being embedded in the organisation. This is a general and over-riding risk. Without the required commitment and actions of Senior Management TCF cannot be adequately embedded throughout the organisation.

## 3. WHAT TREATING CUSTOMERS FAIRLY IS NOT

Whilst it is difficult to define exactly what TCF is there are many things that the FSA is clear about when explaining what TCF is not. Included in the list of things that TCF is not is: -

- being nice to customers or improving customer satisfaction;
- requiring all firms to offer the same or the very highest level of service;
- an inhibition on the design of new services and / or products;
- a requirement to design different services and / or products for different customers;
- a removal of the customers' ultimate responsibility for deciding what they should purchase. Provided that the services and / or products are properly targeted and marketed and the customer is provided with sufficient, understandable information, responsibility for the decision whether to purchase or not remains theirs; or
- any other increase in the standards of behaviour expected of firms.

#### 4. FSA'S SUPERVISORY APPROACH

The FSA has warned firms that TCF continues to be a priority and has stated that:

- firms must give adequate priority to the fair treatment of their customers;
- TCF is a core part of Senior Management responsibility; and
- they will strengthen their focus on this aspect of firms' management controls so that it becomes a core aspect of their regular monitoring.

In addition, firms are reminded that:

- TCF will be a key feature of ARROW 2 when it is rolled out next year;
- TCF will be looked at in relation to all the thematic work that is undertaken; and
- supervisory tools will be used where appropriate.

However, the FSA has indicated that:

- it does not expect to see immediate change, but will expect only to see change over a reasonable period of time; and
- it will help firms who are making a reasonable effort to address TCF issues.

#### 5. DEADLINE: 31<sup>st</sup> MARCH 2007

The FSA has imposed a deadline of 31<sup>st</sup> March 2007 for regulated firms to draft, adopt and implement a TCF policy. Implementation will be judged on the evidence that TCF is embedded in behaviours and outcomes within the firm and in its relations with customers.

#### 6. ACTION POINTS

It is important for all firms to note that the FSA intends to be proactive in following up progress on the TCF project. The regulator will continue to undertake thematic visits which will seek to ensure that regulated companies are taking the principle seriously and making active strides towards implementing it. The FSA imposed deadline of 31<sup>st</sup> March 2007 gives regulated firms approximately two months from the date of this bulletin to compose and implement a TCF plan.

Firms that are not able to demonstrate that they are taking the principle seriously, run the risk of further visits or disciplinary action. Whilst institutional clients may benefit from less regulatory protection than retail customers, it is still important that the firm is seen to be treating them in a fair manner.

All regulated firms, if they have not done so already should produce a documented TCF policy as a matter of urgency. This will then need to be embedded within the culture of the organisation. Recommended steps towards producing the policy are as follows:

- Consider what TCF means to your particular firm. The FSA has stated that this is not a "one size fits all" approach and will vary according to the size, permissions and client base of the firm. It is important to place TCF in context.
- Identify the crucial business areas in which TCF is applicable to the firm and the steps which can be taken to implement this. This may be as basic as a commitment to handling complaints promptly or returning a call promptly.
- Document the steps which can be taken in these areas to ensure fair treatment of customers. Draw up an action plan, highlighting the crucial ways in which the firm will demonstrate a commitment to TCF and how it is intended to go about this.

It is important to note that the TCF project is not a "black box". Having a clearly set out and documented TCF policy is a good start. However, this is not a one-time project. Thematic visits from the FSA will look into how far the TCF culture is embedded within the firm and the steps which are being taken to ensure this remains fit for purpose. Once the policy has been drafted in principal, further steps are required to ensure its successful implementation. Suggested measures to achieve this goal are as follows:

- Carry out an audit of existing working practices. Having identified how the firm can demonstrate a commitment to TCF, it is then necessary to ascertain how far current practices go towards reaching the identified levels.
- Draw up an action plan to be implemented as soon as reasonably possible and to bring each identified area up to the identified standard. This should specify actions to be taken, by whom and by what date.
- Implement TCF within the firm's risk assessment. This will highlight the major issues faced going forward.
- Hold staff briefing sessions if appropriate bearing in mind the size of the company. This will ensure all staff understand the purpose behind the TCF initiative and what is expected of them in their role.
- Carry out regular TCF reviews. These will help to ascertain how far the firm has managed to meet its objectives in relation to TCF. Reviews should also encompass any changes within the company itself or the regulatory environment and whether or how these may cause objectives to vary.

It should be emphasised that this is not an exhaustive list and it is not possible to standardise TCF. Senior Management will need to consider each stage in context and decide the best way to proceed based upon the needs of the firm.

## 7. ADDITIONAL INFORMATION

For firms requiring additional information on what the FSA is looking for and how this may apply in terms of their business, there are a number of papers available from the FSA website. We would particularly recommend firms to look at "Treating Customers Fairly - Towards Fair Outcomes for Customers" and "Treating Customers Fairly- The Consumer's View". These are available from the following web addresses:

[http://www.fsa.gov.uk/pubs/other/tcf\\_towards.pdf](http://www.fsa.gov.uk/pubs/other/tcf_towards.pdf)  
<http://www.fsa.gov.uk/pubs/consumer-research/crpr38.pdf>

Alternatively, if you wish to discuss the implications of TCF further, please contact your usual consultant at Grainger Consulting.

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