

Why you need to act on the FCA's Consumer Duty now

The FCA has published its second consultation (CP21/36) about its proposed Consumer Duty, and includes responses to the feedback it received on its first consultation (CP21/13) in May 2021.

We summarise the FCA's proposals, and provide a high-level view of the legal, regulatory, and market implications of the Consumer Duty.

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The Consumer Duty is due to be implemented by 30 April 2023 and its form is not likely to change substantially.

Given the time required by firms to be ready for the changes, the likelihood that the FCA will want to use its new powers to demonstrate their use and effectiveness, and the potentially severe consequences of breaching the Consumer Duty, we recommend that firms that have, or expect to have, retail customers prepare now.

Importantly, the new duty will also catch firms in a distribution chain with end retail customers, even where those firms do not have a direct contractual relationship with, or treat as their regulatory client, the retail customer. Many firms will therefore need to make changes to their arrangements even though they do not have retail clients.

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What is the purpose of the Consumer Duty?

The FCA's aim in introducing the new rules is to create a higher standard of consumer protection in retail markets and to reduce the level of harm to retail consumers. In CP21/36 the FCA stresses that it cannot meet this objective without new rules and emphasises that a "reset" is needed, backed up by assertive supervisory and enforcement action. Fundamentally, the FCA is not satisfied with the consumer outcomes it is seeing against the baseline of existing requirements under the Principles, PROD and the existing COBS and ICOBS client best interest rules and it wants standards to rise.

The Consumer Duty is therefore envisaged to address a wide range of problems, from consumers receiving inadequate information from the firms that they deal with, through to receiving poor service and being mis-sold products and services.

Part of the FCA's rationale in framing a broad duty is to force firms to place the consumer at the centre of their business, rather than focusing on a "what can we get away with" attitude to compliance with detailed conduct rules. Instead, there is a focus on "getting it right first time". The FCA also hopes that the Consumer Duty will be "future-proof"; that is, broadly applicable regardless of changes in technology and market practice.

Several long-term developments provide the context for this policy initiative. First, the FCA's remit has expanded substantially to include consumer credit firms and encompass around 51,000 regulated firms. Second, there have been several high-profile failures of regulated firms, including Woodford and London Capital & Finance, for which the regulator has received substantial criticism. Third, the Financial Services Compensation Scheme (FSCS) has paid out significant amounts to consumers who have suffered harm, and with it, the FSCS levy has grown rapidly, to the complaints of the industry. Fourth, the £38bn payout by credit providers for the systemic product failures of payment protection insurance (PPI) has demonstrated to regulatory policy makers that additional tools to force financial services businesses to think very carefully about their retail customers are justified in the public interest.

The regulator's challenge is to deliver a policy that can cover all regulated retail firms, while providing sufficient detail as to be practical. The undoubted intention is to push more responsibility on to firms for their good behaviour, now that close supervisory scrutiny is not possible for so many regulated firms, while holding out the general threat of enforcement. The quid pro quo for the industry is a hoped-for reduction in the numbers of bad actors in the market, and consequently fewer FSCS pay-outs and reputational damage incurred by well-behaved firms.

The new proposals are, however, also intended to allow regulatory flexibility for the FCA and it has expressly stated that it expects the implementation process to be "iterative" as it works with firms and other stakeholders such as the Ombudsman to identify examples to help firms embed the Consumer Duty. For firms this raises the prospect of a degree of uncertainty around compliance with the new requirements and we offer our thoughts on firms' implementation projects below.



What does the Consumer Duty require?

The Consumer Duty comprises three related elements.



1. A Consumer Principle

A broad statement of the standards of behaviour expected from firms. After consultation, the FCA has settled on: "A firm must act to deliver good outcomes for retail clients".



2. Cross-cutting rules

A development of the Consumer Principle across the various areas of firm conduct. Rules that would require firms to take reasonable steps: (i) to act in good faith; (ii) to avoid foreseeable harm to customers; and (iii) to enable customers to pursue their financial objectives.



3. Four outcomes

Further detailed expectations for the firm-consumer relationship. A set of rules and guidance that will determine firms' conduct in relation to (i) communications; (ii) products and services; (iii) customer service; and (iv) price and value.

The FCA will disapply its existing Principles 6 (a firm must pay due regard to its customers and treat them fairly) and 7 (a firm 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) where new Principle 12 applies. This is because, in relation to retail customers, Principles 6 and 7 overlap with the Consumer Duty contained in Principle 12. The FCA has accepted the argument that it does not need duplicative content in its Principles to achieve its objectives. However, Principle 12 will be supported by extensive new rules and guidance (both Handbook and non-Handbook guidance) incorporating the existing Treating Customers Fairly outcomes and much new material which will require significant work by firms to assess their current and future business practices before and after the Consumer Duty takes effect in April 2023.

The Senior Managers and Certification Regime's individual conduct rules will also be amended to reflect the Consumer Principle and the cross-cutting rules.

In delivering the above, the standard expected to be achieved by firms according to the FCA is one of reasonableness, to a tortious standard, and so the question will be what might reasonably be expected of a hypothetical firm which is in the same position as the given firm which is being assessed for possible breach. The FCA also emphasises that the rules do not create a fiduciary duty where one does not already exist between a firm and its client. This is helpful.

The FCA initially proposed to introduce an accompanying private right of action but has reached the conclusion that the existing consumer redress system is likely to be more appropriate. The FCA is working with the Financial Ombudsman Service on improvements and holds out the option to introduce a private right of action in the future.



Is this really new or is it just a relaunch of what has really always been FCA expectations?

Our view is that a well-run firm which already places customers and their interests, at the heart of its business model should not need to make extensive changes to its business. To that extent, the Consumer Duty is not fundamentally brand new.

However, the FCA has described its approach to the Consumer Duty as an iterative one, as outlined above. Consequently, at this stage, it is not possible to gauge the full impact of this recalibration in FCA's expectations. What is clear is that the requirements will have a broad reach, catching firms which:

- offer services and not just products to consumers. Many of the rules in PRIN 2A apply to "products". However the term "product" has a new definition under the Handbook Glossary which also covers the provision of a service in the course of a regulated activity. The reach of this is therefore broad and wider than current PROD rules for example; and
- do not have any retail client permissions or direct client relationships but hold a place in a distribution chain with consumers. This means that firms which have no retail expertise potentially and rely entirely on the "agent as client" rule under FCA Handbook will be caught by PRIN 2A. Their SMFs will need to be compliant with the changes in COCON.

Our view is that the majority of firms will need to enhance their processes, including in respect of the following key areas.

- **Identifying customer "need" or "demand"** prior to the launch or adaptation of a product or service. The business case for a new or changed offering will have to be customer-centric. It is not enough just to have a general firm focused intention to boost revenues/profits. There must be a demonstrable and well-researched customer need to be fulfilled.
- **Firms' specification documents when launching or changing products or services.** These will need to assess in detail all of the steps or actions, communications and customer support services which are provided in the lifecycle of the product or service. In our view, this is likely to extend the role of in-house counsel and compliance when signing off propositions from a legal and compliance perspective.

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- **Determining value.** The Consumer Duty imports “fair value assessments” which are familiar in the asset management industry due to the Asset Management Market Study and requirements in COLL 6.6. However, these assessments will extend more broadly into other sectors and, as outlined above, services as well as products.
- **Robust testing and review.** For many firms, product and service review processes will need to be enhanced. These processes must not pay lip service or just be designed to create a paper trail of governance. There needs to be an assessment of the outcomes for clients which will need to include robust scenario analysis and present both qualitative and often quantitative data, sufficient to be scrutinised by the firm’s SMFs.
- **Potentially vulnerable customer (PVC) policies.** Firms will in our view need clear PVC policies which are tailored to the products and services being offered. These policies cannot set out theoretical good intentions to identify and look after vulnerable clients. They must leverage adjustments to the firm’s approach to its products and services where required in order to secure good outcomes for those clients.

The above contains a sample of the steps we think firms should be taking. More generally, we recommend a “shoes of the consumer” test. SMFs and other individuals in a firm considering if a proposed action, service, or product is compliant with the Consumer Duty should ask themselves if they would personally be content as a recipient of that arrangement, disclosure, product or service and if they would consider that it represents a fair and reasonable outcome for them, and (taking into account all the circumstances), a good bargain. This does not of course mean that all potential harm for the consumer must be eliminated.

We also recommend a careful gap analysis approach to assessing the rules in the Draft Handbook Instrument annexed to CP 21/36 and applying these requirements against the arrangements each firm currently has in place. The rules should be considered and applied at product, service and arguably even “product or service feature” level and not just assessed at firm wide level. Notwithstanding our comments above about the extent of each firm’s task to implement the Consumer Duty, in our view it is unlikely to be enough to view the Consumer Duty as a simple exercise in repapering PROD paragraphs in compliance manuals, distribution and co-manufacturing agreements and adding an additional line or two in compliance reports to the governing body. The new obligations call for a holistic assessment.

It is likely that implementation will also require firms to coordinate with others in the supply chain in many cases. Achieving compliance with the Consumer Duty may in many cases be something that firms cannot achieve as a solitary task.

Q How will the Consumer Duty work in practice?

The FCA's second consultation seeks to clarify some of the practical issues raised in response to its first consultation. Some of these clarifications include the following expectations.

- That firms with retail clients will monitor their ongoing compliance with the Consumer Duty; specifically, to:
 - identify and manage risks to good outcomes for consumers;
 - spot bad outcomes and identify the root causes;
 - have processes in place to change products, services, policies, and practices to address any risks or issues; and
 - be able to demonstrate how they have identified and addressed issues leading to poor outcomes.
- The expectation that firms can distinguish between different groups of clients and identify those that are receiving worse outcomes.
- The expectation that the firm's board or management body will consider at least annually a report on whether the firm is acting to deliver good outcomes for its clients consistent with the Consumer Duty. There should be a thorough assessment and sign-off as noted above.
- Firms should produce and regularly review management information related to compliance. The type of data will vary depending on the nature and scale of the business.

However, the second consultation paper still leaves some grey areas, and raises some knotty issues, around application. For example:

- **UK UCITS management companies** with non-retail target markets who receive information from distributors that there may be occasional retail investors in the fund. Although the fund is designed for and targeted at professional investors, to what extent do the ad hoc sales out of target market bring the product into scope of the Consumer Duty?
- **Non-UK managers and manufacturers of underlying products** who fall out of scope on the face of it by virtue of the fact they are not UK authorised, but are indirectly caught by contracts or commercial arrangements – how should these firms respond to the new Consumer Duty?
- **Firms relying on professional client opt-up processes** who have no retail client permissions, but have to interact with would-be retail clients to explain the process to be treated as elective professional clients – how can these firms update their client categorisation and onboarding processes to ensure compliance with the new Consumer Duty?
- **Firms in a distribution chain** who are, in accordance with the new rule at PRIN 3.2.7R, subject to Principle 12 and PRIN 2A only where they are able to determine or materially influence retail customer outcomes – how are these firms meant to decide whether they do have this ability to determine or influence retail customer outcomes, if they are not interacting directly with the end investor?

These questions (and more) are not wholly resolved by the Consumer Duty materials published so far by the FCA, although they may be assessed in the policy statement which is due to be published by 31 July 2022.

Q How will the regulator enforce the Consumer Duty?

The FCA sees the implementation of the Consumer Duty as an integral part of its transition to become a data regulator. This suggests that there will be a heavy expectation of increased firm reporting as the regulator seeks to intervene based on information that it has received. Firms can expect more supervisory focus on their capacity to generate and accurately report data. It is likely that data points will be standardised among types of regulated business over time, so that the FCA is able to make meaningful market-wide comparisons.

At the outset it intends to act against the most serious instances of wrongdoing. The FCA's broader reforms to and integration of the regulator's approach to authorisation and supervision, including tools such as thematic reviews, feed into this. In turn, supervision is likely to closely inform the FCA's policy developments and communications to the market.

In time, the FCA expects to act in a more preventative manner, seeking to identify and intervene before harm occurs. This could mean not only more rapid and prescriptive guidance and rule-making but also greater use of powers such as product intervention bans (previously used for instance, in respect of speculative mini-bonds and contingent capital instruments sold to retail investors). Much will depend on the FCA's clear and early communication of its concerns to avoid too many surprises for the market.

Q What is the timing?

The timeline for implementation is aggressive. Between the finalisation of the rules in 2022 and implementation by 30 April 2023, firms will have roughly a year to prepare for and achieve initial compliance.

The Consumer Duty will be introduced during a period of ongoing regulatory flux, in which several regulatory reviews are underway and new rules will be brought in. For example, the Consumer Duty requires firms to undertake a thorough review of their investor communications. At the same time, the UK is due to review its investor disclosures regime and has, earlier this year, implemented changes to the PRIIPs disclosure for retail investors. Firms will need to embed Consumer Duty considerations into their regulatory change projects and vice versa.

It is evident that the Consumer Duty will be the primary policy focus for most FCA regulated firms over the coming year, and it will be the focal point for both business change and conduct. Firms that fail to act in good time are more likely to face problems further down the line.

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How can Macfarlanes help?

We encourage firms that would like to engage further in understanding and implementing the rules to contact us. We are already advising clients on their response to the incoming Consumer Duty and preparing for the 30 April 2023 deadline.

To help address the many challenges, we have designed an inventory of Consumer Duty materials needed to ensure compliance. Our objective is not to “copy out” the new requirements, but assist firms to develop materials which demonstrate and document what in practice the firm does to achieve compliance.

If you would like to speak to us about your own implementation project or discuss our materials, please contact any of our Consumer Duty contacts.

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