

CITY REGULATOR CONFIRMS FINAL RULES FOR NEW UK CONSUMER DUTY AND GIVES FIRMS MORE TIME TO COMPLY

29 July 2022 | London

FCA finalises rules for consumer duty to retail clients as main implementation deadline pushed out to summer 2023

The FCA has [published](#) the [final rules and guidance](#) and accompanying [non-Handbook guidance](#) relating to the new Consumer Duty (the **Duty**). While the nature and scope of the Duty remains largely unchanged in most areas, the final rules and guidance contain some significant changes and clarifications relating to how the Duty will apply in relation to distribution chains, closed books, wholesale markets and funds and asset managers and where firms provide products or services to occupational pension schemes.

Helpfully, firms have been given more time to implement the changes needed to comply with the Duty. Under the revised timetable, firms will be required to apply the Duty to:

- new and existing products and services that are open to sale (or renewal) **by 31 July 2023** (rather than 30 April 2023); and
- products and services held in closed books **by 31 July 2024**.

However, this implementation period is still a challenging one. The FCA expects firms' boards (or equivalent management body) to have agreed an implementation plan **by the end of October 2022** and for manufacturers to have completed reviews of existing open products and services **by the end of April 2023**. Firms should expect to be asked to share their implementation plans and related board papers and minutes with their FCA supervisors and be challenged on their contents.

Although some of the examples included in the guidance cite particular types of firms, sectors or products, the FCA expects firms to review all of the examples and consider how they may be relevant to their business models and practices. In each of the outcome chapters, the FCA has also included questions firms can expect the FCA to ask them about how they are delivering the Duty. Firms should use these to guide their internal discussions at all levels.

THE CONSUMER DUTY

Once in force, through a new Principle 12, the new Duty will require firms to "***act to deliver good outcomes for retail clients***".

This overarching Principle will be underpinned by **three cross-cutting rules** requiring firms to:

- **act in good faith towards retail customers;**
- **avoid causing foreseeable harm to retail customers;** and
- **enable and support retail customers to pursue their financial objectives.**

The FCA expects the new rules to **promote good outcomes** in the following four areas:

- **products and services;**
- **price and fair value;**
- **consumer understanding;** and
- **consumer support.**

KEY CHANGES FROM THE CONSULTATION PAPERS

The FCA has been consulting since 2018 on the introduction of the Duty with consultation papers in [May](#) and [December 2021](#).

As well as extending the implementation timetable, the FCA has amended the final rules and guidance relating to the Duty with a view to addressing some specific concerns raised in response to its most recent consultation and to clarify how it expects the Duty to be applied in different contexts.

Territorial scope and perimeter of the Duty

- The FCA has reaffirmed the scope of the Duty, confirming that it will apply to "*retail market business*", the meaning of which has been clarified, including by adding in express exclusions, such as one relating to the manufacture of products only marketed and approved for distribution (directly or indirectly) to non-retail customers.
- The FCA has confirmed the meaning of "*retail customer*" will be determined in line with the approach taken in existing Sourcebooks. In doing so, the FCA has largely rejected responses that called for SMEs to be removed from the scope of the Duty. To the extent a Sourcebook applies to a firm's dealings with an SME, that Sourcebook will now need to be read with the Duty in mind.
- In terms of the territorial scope of the Duty, the final rules confirm that the Duty will only apply, at least directly, to firms conducting regulated activities in the UK, firms in Gibraltar selling into the UK and firms in the temporary permissions regime and financial services contract scheme following the UK's withdrawal from the European Union.
- The FCA has also updated the rules and guidance to reconfirm and clarify that:
 - a firm that is distributing a product or service developed by a firm outside the UK must take "*all reasonable steps*" to understand the product or service, the target market it would serve and the value it provides in order to ensure it will be distributed appropriately; and
 - for firms dealing with non-UK customers, the Duty applies in the same way as existing sectoral Sourcebooks or other sectoral rules or guidance although the guidance recognises that there may be limitations on the information the firm can obtain to assess the outcomes for non-UK customers.
- There has been some clarification that wholesale markets firms remain out of scope, and the concept of "*non-complex financial instruments*" has been removed but partially integrated into the definition of "*retail market business*".
- More nuance and complexity arises in the context of distribution chains (see below).

Closed books

- Further guidance has been included on how firms should apply price and value rules to existing products and services, including closed books. The final rules confirm that a firm would not be required to amend "vested" contractual rights where it identifies an existing or closed product that is not fair value.
- There are, however, material limitations to this:
 - the scope of what constitutes a vested right seems very limited. In particular, the FCA's view is that, if a contract allows the customer to terminate without paying an exit charge, the firm will not have an expectation that it can exercise future rights (including future payments of charges), and so those future rights will not be "vested" This narrow interpretation means that the FCA's statement that the Duty will not have retrospective effect needs to be read in that context. This will require careful consideration by operators of closed-book portfolios.
 - even where a right is a "vested" right, firms would need to take appropriate action to avoid causing foreseeable harm and provide fair value, such as changing non-vested fees or charges (where doing so would not impact on any vested rights), providing additional support or information to customers, or offering forbearance, such as a pause in payments, to help mitigate any harm.
- Closed-book providers will appreciate the recognition that, for products bought before the Duty comes into force, they may not be able to comply with the Duty in full (e.g. because historic information is not available to them). Those firms must apply the Duty to those books on a best endeavours basis.
- Firms purchasing closed books in the future, however, will be required to gather enough information to understand the product or service design and value, such that it can meet the rules on an ongoing basis. This could represent a considerable additional diligence burden when buying closed books as it would require a reasonably detailed knowledge of the history of the products that are being acquired.

Wholesale markets

- The FCA's original proposal indicated that wholesale markets were out of scope of the new Duty, but the drafting of the proposed rules and the non-Handbook guidance created ambiguity around the precise impact on wholesale firms, in particular, where they could influence material aspects of the design or distribution of retail products or where they are part of a distribution chain with a retail customer at the end.
- Following feedback from the industry, an attempt has been made to clarify the impact on wholesale firms. There is now some clarification around roles in distribution chains (explored further below) and what will count as a having a "*material influence*" on retail outcomes in that regard. The FCA has also provided specific examples of exclusions from the scope of the Duty in its non-Handbook guidance. These include:
 - the manufacture of products or services only for wholesale purposes;
 - activities relating to non-retail financial instruments; and
 - certain insurance contracts or the administration of benchmarks.
- Credit rating agencies, recognised investment exchanges, recognised clearing houses, CSDs and trade repositories are not subject to the Duty; however, trading venues operated by an authorised person will be caught if their business is otherwise in scope of the Duty.
- Whilst these changes are helpful, a degree of ambiguity remains which will need to be addressed as part of implementation.

Distribution chains

- A number of important clarifications have been included about how responsibility should be divided within a distribution chain:

- the final guidance now repeatedly references firms' responsibilities in respect of the Duty being determined by reference to their ability to "*determine or materially influence*" the end customers outcomes. What this phrase means will be heavily dependent on the context in which it is being considered; and
- the general rule will be that each firm will only be liable for its own acts or omissions. The only exceptions to this should be where regulatory or contractual requirements change the position (e.g. if a firm has contractually agreed to take responsibility for a particular risk or process)
- In addition, new rules have been introduced which will require a firm to notify:
 - the FCA if they become aware that another firm in a distribution chain is not "*or may not be*" complying with the Duty, and
 - other firms in a distribution chain if it thinks they have caused, or contributed to, harm to retail customers.
- More examples have been included in the final guidance to clarify how the Duty will apply to firms in a distribution chain. In this context, the FCA has confirmed that the Duty will apply to firms that create a product or operate a pension scheme for occupational pension scheme trustees where the firm can determine or materially influence the outcome for the scheme's beneficiaries. The FCA has also confirmed that the Duty does not apply to the distribution of group insurance policies or the extension of such policies to new members.

Funds and asset management

- The FCA has maintained the view that managers and depositaries of EEA UCITS and EEA AIFs under the temporary marketing permissions regime will only be subject to the Duty in respect of the communication and approval of marketing communications. Accordingly, they will not be subject to the product and services or the price and value

outcomes, but they will need to comply with the consumer understanding and consumer support outcomes to the extent relevant to marketing communications.

- Listed investment companies, including investment trusts, remain within the scope of "products" for the purposes of the Duty. UK firms will therefore be bound by the Duty in respect of such investment companies where they determine or have a material influence over the design or distribution of, or communications in relation to them. The FCA has, however, acknowledged that the structure of investment companies (i.e. the presence of an independent board of directors) means that firms providing services to such companies are not always able to determine consumer outcomes. In that context, the FCA has issued two important clarifications:
 - firms need only, where reasonably practicable, comply with the Duty "*within the context of their role*"; for example by discussing any concerns it has with the board of the investment company, even if the firm cannot compel any change; and
 - on the price and value outcome specifically (something that is particularly problematic in the case of listed investment companies), the FCA has clarified that it would not expect firms to base assessments of value on "*external factors largely out of their control*". Instead, the FCA expects firms to consider the value of the charges they do control, including any ongoing charges, within the context of the net asset value. It is still unclear what the expectations will be in this regard, but they will likely fall short of COLL-style assessments of value.
- The observation made above in relation to UK distributors having to take "*all reasonable steps*" to comply with their own obligations around, among other things, the price and value outcome where distributing a non-UK manufactured product may have particular impact on asset managers with large stables of overseas funds marketed to retail in the UK. UK based retail facing distributors may now consider they require from non-UK AIFMs and UCITS management companies information resembling COLL-style assessments of value.
- In the context of wholesale products, the FCA has also helpfully clarified that a manager of an institutional investor-only fund will not become subject to the Duty if a third party, without the manager's involvement, invests into the institutional fund via a retail fund of funds.

Governance and oversight

- In response to concern among consumer organisations that the proposed monitoring and governance requirements that will apply to firms are not robust enough, the FCA has:
 - included new rules to make clear it expects the Duty to be reflected in firms' strategies, governance, leadership and people policies, including in relation to remuneration and incentives at all levels; and
 - amended its guidance to make clear firms should have a champion at board level (or equivalent governing body) who, along with the Chair and the CEO, ensures the Duty is discussed regularly and raised in all relevant discussions. The champion should be an Independent Non-Executive Director, where possible.
- The FCA has also set out a number of questions it expects a firm's board (or equivalent body) to be asking on a regular basis, and which firms can expect the FCA to ask of them.

Foreseeable harm

- The FCA has reverted to its original proposed wording for the cross-cutting rule on avoiding foreseeable harm to make clear that firms are required to avoid "*causing*" foreseeable harm. This is designed to address concerns that a firm could otherwise be held to be responsible for foreseeable harm that occurs which is outside of its responsibility or control. However, the FCA makes clear this does not mean a firm does not need to consider the actions of other parties, particularly where it is part of a distribution chain (with additional rules applying in that context, as outlined further below).
- The guidance has been updated with examples of foreseeable harm and to make clear that what is foreseeable is dynamic. This means firms need to stay abreast of and respond to new or emerging sources of harm which may come to light through consumer complaints, management information, press reporting and the FCA's supervisory communications.

Consumer understanding and support

- Responding to feedback that references to communications being suitable for the "average" customer are unclear and could lead to firms focusing on the needs of the average customer at the expense of customers in vulnerable circumstances or with diverse needs, the final rules have been amended to clarify that the FCA wants firms to ensure their communications are likely to be understood by the customers intended to receive them. While this does not mean firms need to identify the individual needs of each customer, it does mean they need to consider the range of needs in their target market, including characteristics of vulnerability, and factor this in to how they design and sell products and services and support their customers. Firms manufacturing or distributing products with widely drawn target markets will therefore need to pay particularly close attention to this aspect of the Duty.

Vulnerable customers

- As well as monitoring the outcomes for all retail customers, firms will need to pay particular attention to the outcomes for customers with characteristics of vulnerability or customers who share specific protected characteristics, under the Equality Act 2010 or equivalent legislation. Where such customers receive systematically poorer outcomes this may indicate that the firm is not meeting the Duty for those groups.

IMMEDIATE REFLECTIONS

Firms face a significant task over the next 12 months embedding the new Consumer Duty within their organisation and identifying and implementing the changes needed, initially in respect of new and existing products and services, to comply with the Duty. This task is not helped by the fact that there remains significant areas of uncertainty over what the Duty means and how it should be applied in a number of contexts, including:

- the particular circumstances in which the Duty will need to be considered at an individual consumer level as opposed to a target market level;
- when a firm in a distribution chain will be considered to be in a position to "*determine or materially influence*" the outcomes for retail customers;

- how far a UK distributor of a non-UK product will need to go to take "*all reasonable steps*" to comply with its price and value obligations; and
- how the principles of reasonableness and proportionality should be applied, where relevant.

Despite assurances that the Duty would not have retrospective effect, it is clear from the FCA's response and the final rules that firms will need to give careful consideration to how it impacts products manufactured and sold before the duty comes into force, including closed books. According to the final guidance, this may include making changes to future payments by a consumer relating an existing or legacy product or service that is not considered to offer fair value, where a customer can terminate the contract without an exit charge, as the FCA does not consider these to be vested rights. Additionally, firms acquiring closed books in the future will need to consider carefully what information they need from the seller so that they can comply with the Consumer Duty after the acquisition. These issues will be particularly pronounced for firms with long-term products (e.g. mortgage providers and life insurers).

Firms in distribution chains will have to carefully consider when they consider themselves to be able to "*determine or materially influence*" outcomes for retail customers. In the context of complex supply chains, the extent of a firm's influence may not be clear, and overlapping responsibilities may mean the analysis is complex. The application of the Duty to a distribution chain may, therefore, involve considerable co-operation and discussion between the parties in that distribution chain.

While the approach being taken to UK distributors of non-UK products is consistent with the FCA's objective to maintain consistency across products sold to UK retail customers, this potentially opens up a significant workstream for UK distributors in respect of overseas fund products that are distributed to UK retail customers, given that the manufacturers of these products will not be subject to the price and value outcome or the assessment of value rules under existing regulations such as COLL. Compliance may look different across products depending on various factors such as the size of the distribution chain and the UK distributor's position in it, the contractual relationships between the UK distributor and the manufacturer, and whether the UK distributor is in the same group as the manufacturer or not.

While the FCA has said it will support firms with their understanding of the Duty and the changes needed to implement it during the implementation period, in many areas the extent of the Duty and its practical implications will only be known as contentious points and consumer complaints are considered by the FCA and the Financial Ombudsman Service respectively once the new Duty is in force.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



SAMANTHA BROWN
MANAGING PARTNER
OF EPI (WEST),
LONDON
+44 20 7466 2249
Samantha.Brown@hsf.com



NISH DISSANAYAKE
PARTNER, LONDON
+44 20 7466 2365
Nish.Dissanayake@hsf.com



HYWEL JENKINS
PARTNER, LONDON
+44 20 7466 2510
Hywel.Jenkins@hsf.com



**GEOFFREY
MADDOCK**
PARTNER, LONDON
+44 20 7466 2067
Geoffrey.Maddock@hsf.com



MARINA REASON
PARTNER, LONDON
+44 20 7466 2288
marina.reason@hsf.com



TIM WEST
PARTNER, LONDON
+44 20 7466 2309
Tim.West@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

© Herbert Smith Freehills 2022

SUBSCRIBE TO STAY UP-TO-DATE WITH INSIGHTS, LEGAL UPDATES, EVENTS, AND MORE

Close

© HERBERT SMITH FREEHILLS LLP 2023