Interpreting "material influence" over retail customer outcomes for the purposes of the new Consumer Duty in primary equity capital markets offerings by investment companies/trusts

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IC	an investment company, including investment trusts and other alternative investment funds such as REITs and VCTs, all as falling within the FCA Handbook definitions of "AIFs" or "collective investment schemes"
IM	an IC's investment manager, which may or may not also be the AIFM
Broker	a firm that is acting as underwriter, book-runner, placing agent, corporate broker and/or sponsor to an IC, or in the capacity of a financial adviser to the IC, on a primary capital markets equity or equity-linked offering

A. Introduction

1. The new FCA Consumer Duty ("**Consumer Duty**") introduces new requirements for firms relating to the standard of care they provide to "retail customers"[1]. It will apply when firms are conducting "retail market business" (PRIN 2A.1.3G), including where firms' direct clients are not "retail customers" but actual or potential "retail customers" are part of the distribution chain, provided that firms "determine or materially influence retail customer outcomes" (PRIN 2A.1.13G, PRIN 2A.1.14G). The definition of "retail market business" excludes, among other things, regulated and ancillary activities in relation to offers of certain financial instruments, and any associated promotional communications, that meet certain criteria. This exclusion (commonly referred to as the "primary markets exemption") means that the Consumer Duty will not apply to firms a) acting as underwriters, bookrunners, placing agents, corporate brokers or sponsors to an issuer, or in the capacity of a financial adviser to an issuer, and/or b) approving a financial promotion, in either case in relation to all primary capital markets equity offerings except for primary capital markets equity offerings of collective investment schemes or AIFs (as defined in the FCA Handbook) or (for completeness) structured finance products. The FCA definitions of collective investment schemes and AIFs include funds and investment trusts and are collectively defined in this note as "**ICs**" (see above). For primary capital markets equity offerings and promotional communications of ICs, Brokers will need to consider the extent (if any) to which they "determine or materially influence retail customer outcomes" in carrying out their role.

2. This note discusses the role of Brokers in such transactions and assesses the typical facts and circumstances that support the conclusion by a Broker involved on a primary capital markets equity offering for an IC that it is not determining or materially influencing retail customer outcomes by reference to the four outcomes under the Consumer Duty: products and services; price and value; consumer understanding; and consumer support.

[1] Note that the FCA defines the term "retail customer" more broadly than the MiFID term "retail client". Retail customers include *"where a firm carries out activities in relation to an occupational pension scheme, any person who is not a client of the firm but who is or would be a beneficiary in relation to investments held in that occupational pension scheme"*.

3. For the avoidance of doubt the Consumer Duty will **not** apply in the case of:
   a. a Broker acting on a secondary equity capital markets offerings, such as block trades and ABBs for selling shareholders, where the Broker offers and places securities to non-retail customers; and
   b. primary equity-linked offerings to institutional investors pursuant to the exclusion from the definition of "retail market business" for activities carried on in relation to "non-retail financial instruments" (as defined in the FCA Handbook).

B. Product & Services Outcome

1. For the reasons described below, Brokers either (i) should not be considered to be manufacturers for the purposes of the Consumer Duty, and/or (ii) typically do not "determine or materially influence retail customer outcomes" in the context of the product and services outcome. In any event, Brokers will be applying PROD 3, and so the rules relating to the product and services outcome will not apply pursuant to PRIN 2A.3.24R.

2. There are good arguments that Brokers acting on IC primary market issuances are not manufacturers for CD purposes at all. The reasons for this are set out below.

3. The definition of "manufacturer" in the FCA Handbook for PRIN purposes refers to the creation, development, design, issuance, management, operation, carrying out, or (for insurance or credit purposes only) underwriting of a product. Notably, the PRIN definition of "manufacturer" – unlike the "manufacturer" definition for PROD purposes – does not explicitly include "advising corporate issuers on the launch of new investments". In PS22/9, para 2.27, the FCA noted that they were *"amending the manufacturer definition for 'underwriting' to be clear that this relates to insurance and credit activities. This avoids the implication that the Duty applies to primary market activities involved in underwriting the issuance of securities."* This would support the argument that advice on primary corporate issuances is deliberately out of scope of the "manufacturer" definition in PRIN. (However, see below regarding whether Brokers could be regarded as "distributors" for Consumer Duty purposes instead.)

4. In assessing whether Brokers may nevertheless be said to "create, develop [or] design" the equity instruments issued by an IC, there are good arguments that they should not. Just like other PLCs, ICs issue shares that are listed and traded on a stock exchange where they can be bought and sold by anyone. ICs also have independent Boards with fiduciary responsibilities to the company and its shareholders. It is not the shares that are manufactured per se but the IC itself – the defining characteristic of an IC is that it's a fund.

5. Manufacturing decisions on the fund characteristics (e.g. investment policy, gearing and hedging strategy, tax status, structure and terms of the investment mandate etc.) are decisions taken by the IC Board working with its IM. ICs often originate with an established IM who then sources a Board and establishes the company around an investment thesis. Any feedback the Broker may provide in the normal course is typically on how the fund characteristics (as designed by the IM / IC) impact on the marketability of the product to the institutional/professional investor target market, i.e. the Broker's role can be properly characterised as one of bringing an already designed product to market.

6. Even if a Broker were considered to be a manufacturer for Consumer Duty purposes, there is support for the view that the IM (rather than the Broker) has material influence over product design and other matters in FG 22/5 para 2.19 and PS 22/9 p15-16. However, the FCA goes on to say that the IM should, where

reasonably practicable, comply with the Consumer Duty within the context of its role and indicates that the IM's obligations may be limited in practice. The FCA makes no mention of Brokers in this context.

7. Finally, Brokers are deemed to be manufacturers for MiFID product governance purposes (as advisers to issuers on the launch of their securities, which is specifically included within the PROD definition of "manufacturer") and will therefore continue to apply PROD 3 accordingly, meaning the rules relating to the product and services outcome will not apply pursuant to PRIN 2A.3.24R.

8. As well as products, the Consumer Duty also applies to services involving regulated or ancillary activities provided directly to a retail customer, or by one firm to another firm (further to an arrangement[2] between them) for the purpose of enabling the other firm to distribute a product to a retail customer. Brokers that only procure investors meeting the criteria of professional clients or ECPs should therefore automatically fall outside the Consumer Duty, except where the investors directly procured by a Broker are OPSs. As noted above, where a Broker carries out its activities in relation to OPSs, the underlying beneficiaries of the relevant OPSs are treated as "retail customers" for Consumer Duty purposes. However, even in that case, a Broker who (in accordance with an allocation strategy agreed with the issuing IC) allocates shares in the IPO to an OPS or intermediary firms under an Intermediaries Offer would not, absent any other reason, be viewed as having a material influence on outcomes for the underlying beneficiaries of the OPS or the investing clients of those intermediaries. This is because the relevant OPS or intermediary would have responsibility for investment decisions on behalf of OPS beneficiaries or for advising on, or effecting, onward distribution to retail customers, respectively, without any influence by the Broker over such decision making / actions.

9. A Broker would be a "distributor" for Consumer Duty purposes where it "offers, sells, recommends, advises on, arranges, deals, proposes or provides a product". As discussed above, while "advising" features in the "distributor" definition, there are good arguments that Brokers are not in fact advising on the product, but rather giving feedback on its marketability. However, even if a Broker were considered to be a "distributor" by virtue of its role in a primary IC issuance, any direct distribution would be to professional clients or ECPs and (even where these are OPSs or are intermediaries who will ultimately distribute to retail customers) the Broker should not be considered to materially influence retail customer outcomes for the reasons outlined in paragraph 8 above.

C. Price & Value

1. The traditional role of the Broker in helping to price new shares based on price discovery through book-building is not a feature of IC IPOs, which are typically issued at a standard price of 100p. Thereafter the shares trade according to market supply and demand, with underlying NAV as a reference. For follow-on issuance, pricing would be set by the IC and IM and may be informed by book-building conducted by the Broker as well as prevailing NAV.

2. In any event, the offer price is not the 'real cost' of the product to the investor. Although not paid directly by the investor, there are costs and charges that are intrinsic to an investment in the IC that will be accounted for in the investor's investment return. What is most likely to be material to the overall value proposition is the IM's charges – its annual management charges plus performance charges, if any - in return for the IM's services. After all, the IC is dependent on the IM to execute on the investment policy

[2] After discussions with policymakers, AFME believes that a reasonable approach is to understand that an "arrangement" for these purposes is more than mere knowledge that the other firm will or may distribute to a retail customer; it would need to involve some kind of contract or similarly 'formalised' arrangement between the relevant firms.

and generate a return for investors. Brokers do not have material influence over an IM's charges and are not required to undertake an assessment of or challenge another firm's charges (FG 22/5 para 7.31). The IM's charges will be subject to extensive disclosure (prospectus, AIFMD disclosure, PRIIPs KID).

3. In contrast, the Broker charges are 'one off' for a primary market issuance – a commission on proceeds of sale and sometimes a corporate finance advisory fee. These are compensation for primary market activities and distribution to the professional/institutional target market (i.e. the same activities that are excluded from the Consumer Duty in the case of other types of issuer client). Total issuance costs (including Broker commission or charges, legal, accounting and regulatory costs associated with the issuance) are not material, typically around 2% of gross proceeds. These aggregate costs are, in any event, disclosed in the prospectus. In addition, it is the responsibility of the IM and the IC's Board to negotiate the Broker's commission or charges on behalf of the fund with a view to ensuring that the commission / charges (alongside all other costs of the offering) represents a good value proposition for investors (who may ultimately be retail customers in the investment chain) investing in the IC.

4. In conclusion, Brokers may reasonably conclude that they do not determine or have a material influence on the fair value to a retail customer of an investment in an IC having regard to:

    a. the role of the Broker compared to the roles of the IC's Board and IM and their combined influence over the value proposition to investors
    b. the impact of market conditions (outside the control of the Broker, and other parties) on the NAV and share price and therefore on the return on investment
    c. the one-off nature of the Broker's commission / charges and transparency of the total issuance cost in the prospectus, and the fact that the IM and IC's Board have responsibility to assess and negotiate the commission / charges to ensure it represents fair value for investors
    d. the fact that the shares are listed on a public stock exchange where they can be bought and sold freely at prices determined by market forces.

D. Consumer Understanding

1. The FCA provides as an example of firms that can materially influence retail customer outcomes, those firms that can influence or determine material aspects of the preparation or approval of communications that are issued to retail customers (PS22/9 p15, FG 22/5 para 2.13).

2. The Broker will be involved in reviewing and commenting on the IC's prospectus (which is prepared for all investors including retail customers). The prospectus is usually prepared by the IC's legal adviser with considerable input from the IM. Prospectus disclosure is already heavily regulated by the Prospectus Rules, Listing Rules etc. Note too that the IM/AIFM is responsible for a host of additional disclosure for the benefit of investors under both FCA rules implementing AIFMD and PRIIPs regulation. A prospectus must contain information that is necessary and material to an investor (professional and retail alike) to make an informed investment decision and must be written and presented in an easily analysable, concise and comprehensible form. Brokers will already have established processes, governance and practices to satisfy themselves with the standard of their issuer clients' prospectus disclosure. Such Brokers may conclude that this is already reasonable and proportionate to satisfy any obligation a Broker may have for consumer understanding under the Consumer Duty having regard to the context of its role as Broker.

3. In addition, arguably the greater influence on retail customer investment decisions will, in practice, come from promotional materials designed for the retail target market e.g. promotional materials for an

intermediaries offer. These are typically prepared by the IC's intermediary offer agents/advisers and approved by the IM (including as financial promotions for s21 FSMA purposes). Although Brokers may conduct a "light touch" review of the intermediary promotional materials, this will typically be limited to checking that there are no inconsistencies with the prospectus. Ultimate responsibility for these materials will remain with the relevant intermediary / IM, who should therefore be regarded as having the material influence over retail customer outcomes through communications. It is also the intermediary who has discretion to agree (with the IC) allocations to particular retail customers.[3]

4. The IM will normally be the appropriate approver of a financial promotion on behalf of the IC, particularly promotions directed at retail investors / customers. A Broker that does so instead may be more likely to conclude that it has an obligation with respect to the consumer understanding outcome under the Consumer Duty. Even then, a Broker is required by COBS 4 to have policies and procedures or internal controls to ensure compliance with the financial promotion rules in COBS 4, and may conclude that these are already reasonable and proportionate to satisfy any such obligation under the Duty.

E. Consumer Support

1. Provided a Broker is not placing directly with a retail customer, or under an arrangement with another firm to enable that other firm to place with a retail customer, a Broker would not be interacting directly with, or providing support to, retail customers and should, therefore, not (according to PRIN 2A.6.1R) be under a duty to design or provide ongoing support to any retail customer investing in an IC. Such obligations are expected to rest with the intermediary firms engaged to distribute directly to their retail customer clients.[4]

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[3] From an evidentiary point of view, it would be helpful if (where possible) relevant intermediary agreements clarify that the IM and/or intermediary is responsible for the communications with retail customers who might ultimately invest in the IC (whether or not the Brokers are actually party to these intermediary agreements). It is customary for intermediary agreements to do so.

[4] From an evidentiary point of view, it would be helpful if (where possible) relevant intermediary agreements clarify that the intermediary is responsible for interaction with, and support to, retail customers. It is customary for intermediary agreements to do so.

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Notes:

1. AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu
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