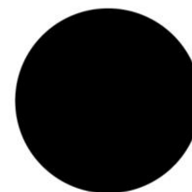
RETAIL DISTRIBUTION REVIEW: SECOND DISCUSSION DOCUMENT ON INVESTMENT RELATED MATTERS

December 2019



FSCA

Financial Sector
Conduct Authority

PART A. Background and purpose

The FSCA's predecessor, the Financial Services Board, published its Retail Distribution Review ("initial RDR paper") in late 2014, marking the start of a multi-year project to reform the regulatory landscape for the distribution of financial services products. Since the publication of the initial RDR paper, the FSB and the FSCA have published a series of status updates on the phased implementation of the RDR proposals. These included a *Discussion Document on Investment Related Matters*, published in June 2018 ("the 2018 Investments Document").

The 2018 Investments Document focused on the impact of certain of the initial RDR paper proposals on the investments sector, inviting feedback on possible regulatory measures to:

- Define the activity of "investment management" and consider the extent to which investment management needs to be demarcated from other forms of discretionary investment mandate;
- Clarify the nature of the legal and business relationships between different types of discretionary investment mandate holders, collective investment scheme management companies and investment advisers, and how best to structure these in the regulatory framework to achieve our RDR objectives; and
- Provide for fee and remuneration arrangements in light of the above, to align with the RDR approach of aligning remuneration with actual activities performed and avoiding unnecessary duplication of costs for the end investor.

Feedback was received on the 2018 Investments Document from commentators representing a wide spectrum of investments sector stakeholders. Twenty-eight entities submitted input. Commentators included six industry associations, and a broad spectrum of financial groups and individual institutions, comprising FAIS Category II FSPs of varying scale and specialisation; investment advisers; asset consultants; CIS management companies; and compliance practices. Understandably, given the broad range of interests represented, views expressed by commentators on most of the regulatory measures proposed in the document diverged significantly.

The FSCA takes this opportunity to thank all of these commentators for their detailed and well-considered contributions to our RDR reform initiative.

Against that background, the purpose of this *Second Investment Matters Discussion Document* is to provide stakeholders with feedback on responses received to the 2018 Investments Document, to share our updated thinking on proposals put forward in that document, and to elicit further stakeholder input on our updated proposals.

In line with the overall structure of the 2018 Investments Document, this document has four key focus areas:

- Section 1: The general investments landscape
- Section 2: Defining and understanding different activities performed under a discretionary investment mandate
- Section 3: Categorising investment advisers within an RDR framework
- Section 4: Implications for remuneration and charging structures.

In each of these areas, the document summarises inputs received on the 2018 Investments Document and then sets out the FSCA's updated position. This document needs to be read together with the 2018 Investments Document. At the start of each Section, for ease of reference, we have therefore set out the applicable questions that were put to stakeholders in the previous document. We also attach the full text of the 2018 Investments Document as *Annexure B* to this document.

Please note that Sections 2 and 3, dealing with defining investment management activities and categorising investment advisers respectively, are the areas where the FSCA's updated position is most advanced. A number of the matters dealt with in Section 4 (remuneration and charging

structures) are to an extent dependent on final proposals in the preceding sections. The FSCA's position on these matters has therefore not yet been significantly updated since the 2018 Investments Document proposals, and our update in Section 4 is therefore relatively more high level than the preceding Sections. Further consultation on these areas will take place in due course.

PART B. Updated thinking based on input received on the 2018 Investments Document

Section 1: The investment landscape

This Section deals with the FSCA's general observation regarding the South African investments landscape, including our observations regarding the complexity of some investment business models and the consequent risks of conflicts of interest and customer confusion. Other key observations related to the potential inadequacy of a broad, "one size fits all" regulatory approach to the activity of investment management; and mismatches between the legal construct of relationships between different entities in the investments value chain and the actual, practical nature of their business relationships.

> ***Question for stakeholder input in the 2018 Investments Document:***
> *Q1. Do you agree with our above observations regarding the investment landscape? If not, where do you disagree? Are there any additional considerations you believe we have overlooked that are necessary to inform our regulatory proposals?*

1.1. Summary of inputs on the 2018 Investments Document

There was general agreement among commentators that the FSCA's description of the investments landscape was accurate, subject to some points of difference on technical details. There was also general acknowledgment that some aspects of current business models and practices give rise to actual and potential conflicts of interest.

However, views diverged widely on the extent to which regulatory intervention is required to address the identified concerns. Opinions varied from arguments that the sector is working well and that no substantive regulatory intervention is required, other than possibly enhanced investor disclosure requirements; to arguments that some business practices are severely compromising fair customer outcomes and require significant regulatory intervention. More "middle ground" views accepted that some level of regulatory intervention would be appropriate, but that this should be proportional to identified risks and not be unnecessarily disruptive. In particular, some inputs highlighted that the business models and practices flagged as potentially conflicted represent only a small proportion of the overall market and that interventions should be appropriately focused to deal with these, without disrupting less problematic models.

1.2. The FSCA's updated position

The FSCA fully agrees that any regulatory intervention we consider should be risk-based and proportional. We do not agree with the position that no structural regulatory intervention at all is required. On the contrary, a number of the detailed descriptions of business models and practices submitted reinforce our view that the regulatory framework needs to provide more clarity regarding the inter-relationships between investors and the different product and service providers in the investments value chain, to reduce regulatory arbitrage and conflict of interest risks.

In particular, the FSCA does not agree that enhanced disclosure requirements are on their own sufficient to address these risks. We do however agree that the quality, consistency and comparability of investor disclosure need improvement in some areas.

We recognise that some of the business models focused on in the 2018 Investment Document (particularly those we described as "model portfolio manager" ("MPP") and 3rd party co-branded models) represent a relatively small proportion of the overall market as compared to more traditional investment management and CIS models. However inputs received, general industry media

coverage, and the FSCA's own supervisory experience show that these types of business models are becoming increasingly prevalent. In particular, the increasing sophistication of technological tools is blurring the lines between investment advice and investment management in the traditional sense. Increased vertical integration of different parts of the investments value chain is also evident. We therefore remain of the view that appropriate regulatory intervention is required to deal with potential conflicts of interest and other conduct risks in these models.

Section 2: Defining and understanding different activities performed under a discretionary investment mandate

This Section covers matters raised under potential Measures 1 to 6 in the 2018 Investments Document, and responses to Questions 2 to 5 of that Document. These questions dealt mainly with identifying and defining different types of discretionary management activity, and the extent to which these should be differentiated in future licensing, fit & proper and / or other aspects of the regulatory framework. The Document discussed four main sub-categories of investment management:

- So-called "traditional" investment management
- Third party co-branded investment management (sometimes referred to as "white label" arrangements
- Model portfolio management (MPPs)
- Mandates held mainly for convenience.

Questions for stakeholder input in the 2018 Investments Document:

Q2. Please let us know whether you agree or disagree with our categorisation of investment management activities into the four broad groupings set out above and our description of each type of activity? If you disagree, where do you disagree and how would you group or describe the activities differently? Suggestions on the appropriate terminology to describe each category of activity will also be welcome.

Q3. Do you agree in principle that the current criteria for a FAIS Category II licence are overly broad and that it is necessary for the regulatory framework to distinguish more clearly between different types of discretionary investment mandate activities? If you disagree, please explain why.

Q4. Please provide your views on the correctness, feasibility and likely effectiveness of each of the possible approaches to discretionary investment mandate categorisation (Measures 1 to 5) set out above. Please let us know if you have any alternative categorisation suggestions.

In particular, please provide your views on –

(i) whether or not different, more rigorous fit and proper standards (including competency financial soundness and operational ability requirements)should apply to investment managers (to be defined) as compared to model portfolio providers (MPPs) and why you hold this view;
(ii) if you agree that different standards should be set for investment managers and MPPs, which standards should apply to providers of a portfolio comprising both existing pooled investments and directly held non-pooled assets?;
(iii) if you agree that different standards should be set for investment managers and MPPs, please provide suggestions on what the key differences between these standards should be; and
(iv) regardless whether you believe that investment managers and MPPs should be subject to different fit and proper standards, whether the current FAIS fit and proper standards for Category II FSP's are adequate and appropriate for investment managers, MPPs, or both or whether you believe any amendments would be required in light of the measures proposed in this paper.

Q5. Do you agree that so-called "mandates for convenience" should continue to be permissible? If not, why not? If yes, please provide your views on the proposed provisos set out under Measure 6. Do you agree that this activity is ancillary to advice provided in relation to the investments concerned?

2.1. Defining "investment management"

2.1.1. Summary of inputs on the 2018 Investments Document

Stakeholders agreed, in the main, that the current scope of activities falling under a FAIS Category II licence is broad, but disagreed sharply on whether this is problematic and hence whether more detailed definitions or categorisation of investment activities are necessary. On the one hand it was argued that a single, broad, holistic definition is appropriate to allow flexibility across different investment management activities; while others felt strongly that the current broad scope allows entities to perform complex investment management activities without adequate expertise.

A point was raised that distinguishing different activities within the overall scope of the investment management activity is only necessary to the extent that different licencing and fit and proper requirements are to be imposed. Some commentators argued that the distinction between advice and investment management is more important than the distinction between different types of IM; and an argument was also made that over and above any distinction between different investment management activities, the regulatory framework should also distinguish between different types of FAIS Category I activities (advice and intermediary services) in the investments space.

2.1.2. The FSCA's updated position

Defining "discretionary investment management"

The FSCA remains of the view that an overarching definition of the activity of "investment management" is required. This is a necessary approach in an activity-based regulatory approach such as that of the RDR as a whole. It is also the approach proposed in the activity-based legislative framework to be introduced by the Conduct of Financial Institutions (COFI) Bill, where "discretionary investment management" is one of the activities that will require a licence from the FSCA under the COFI framework.

The FSCA therefore invites suggestions on a possible definition of "discretionary investment management", or on the key elements that such a definition should cover. Our current thinking is that the definition should cover the following[1]:

- Obtaining a mandate from a financial customer to apply an agreed level of decision making, on behalf of the financial customer;
- after establishing and agreeing the financial customer's investment objectives and investment risk appetite;
- identifying, selecting, acquiring or disposing of financial products, financial instruments or other assets (or identifying and selecting other investment managers to perform this activity);
- in accordance with an investment strategy and investment objectives set out in the mandate;
- in accordance with any parameters, limits, thresholds or other instructions set out in the mandate;
- handing any assets acquired over to a custodian or nominee for safekeeping.

It should be noted however that the introduction of a definition of "investment management", and further sub-categorisation of this activity as discussed in Section 2.2 below, does not necessarily need to be deferred until the COFI Act comes into operation. As pointed out in various RDR update publications, in the event of the implementation of the COFI Act being materially later than expected, the FSCA will use existing available regulatory instruments to effect our RDR reforms

[1] Note that some of these elements may be better placed in the "sub-definitions" of proposed sub-activities of investment management. The overarching definition could in turn incorporate these sub-definitions by reference.

where we consider this necessary. Depending on the timing of the COFI legislative process, the FSCA will therefore consider appropriate adjustments to the current FAIS licensing framework to give effect to our proposals regarding invesment management activities. Any such change would of course be subject to our ordinary prescribed consultation processes.

Potential regulatory arbitrage between advice and discretionary investment management – including through "copy trading".

The FSCA agrees in principle that the distinction between advice and investment management should be sufficiently clear to reduce the risk of arbitrage between the regulatory requirements for each activity. Concerns have been raised that a FAIS Category I investment adviser is in effect able to "copy" the services of a Category II investment manager (particularly the services of a multi-manager / MPP), through a process of actively identifying and recommending investments in various combinations of underlying portfolios on an ongoing basis, without needing to meet the more rigorous regulatory requirements for actual investment management. The FSCA's view is that, provided all applicable regulatory requirements for the provision of advice are complied with – including all applicable competency, disclosure and suitability requirements – it is not feasible or desirable to try to impose limits on the extent of these advice activities at present. There is arguably a natural ceiling on the extent to which an adviser could "copy" investment management activities in this way without holding a discretionary mandate, as the need to obtain individual investor instructions and consent for every transaction will become operationally unmanageable across a large investor base.

The FSCA has however been alerted to the potential risks of so-called "copy trading"[2] technology driven models, which enable financial market participants (including less experienced participants) to automatically replicate trading decisions of other investors on trading platforms, thus creating a new type of investment offering. The FSCA plans to undertake further technical work to assess the risks of these models and how best to position the activities concerned within our regulatory frameworks, to ensure they are appropriately regulated. We will also consider the responses of regulators in other jurisdictions to these models.

The FSCA is also mindful of the need to ensure that our proposals regarding "mandates for convenience" (see Section 2.4 below) do not have the unintended effect of increasing the risk of regulatory arbitrage between advice and investment management requirements.

Application of requirement for FAIS Category II FSPs to assess investor suitabilty.

Industry representatives have also requested clarity regarding the application of the current requirement in the FAIS Code of Conduct for Administrative and Discretionary FSPs, requiring investment managers to obtain certain information from customers to identify suitable products, before entering into a discretionary mandate.[3] In particular, clarity has been requested as to whether this requirement needs to be complied with by the Category II FSP concerned where a customer invests in a third party co-branded CIS portfolio managed by that Category II FSP. The concern is that, if the requirement does apply in this scenario, this would be inconsistent with the fact that no such requirement applies where a customer invest in an "ordinary" (not 3rd party co-branded) CIS portfolio. The FSCA takes this opportunity to confirm that this requirement only applies where the investor grants a discretionary mandate to the Category II FSP concerned. Where the transaction concerned is only an investment directly into a CIS portfolio – whether 3rd

[2] Also sometimes referred to as "mirror trading", "coat-tail investing", "social trading" and other terms.

[3] See section 4(b) of FAIS Board Notice 79 of August 2003.

party co-branded or not – no such mandate is granted by the investor to a Category II FSP and the requirement will therefore not apply.

New questions for stakeholder input:

Q1. Please provide your views on the proposed elements to be covered by a definition of "discretionary investment managements". Any suggestions for a draft definition are welcome.

Q2. Do you have any suggestions on how best to mitigate the risk of regulatory arbitrage between advice and discretionary investment management? In particular, do you agree that the practice of "copy trading" presents such a risk and do you have any suggestions as to an appropriate regulatory treatment of this practice?

2.2. Categorising investment management activities

2.2.1. Summary of inputs on the 2018 Investments Document

Most stakeholders agreed that the FSCA's descriptions of the four types of discretionary investment management activities in the document were accurate, but many expressed doubt that these four activity types were an appropriate basis to use for sub-categorising licences and fit and proper requirements. Views on the extent to which sub-categorisation is required at all were aligned with the applicable commentator's view on whether the current broad scope of the FAIS Category II licence criteria is cause for concern (see discussion under Section 2.1.1 above). Some commentators, including a large industry association, argued that no sub-categorisation of investment management activities is necessary, other than carving out "mandates for convenience" from the current scope of investment management.

A compelling case was made that the four investment management sub-categories the FSCA described in the 2018 Investment Document inappropriately conflated differences between activities performed with differences between the legal structures or product "wrappers" used for the resulting investment offering. The view was that, in line with the RDR activity-based approach, any sub-categorisation should depend mainly on the activity concerned. A variation of this argument was a proposal that, in line with an activity based model, a distinction could be made between providers performing actual asset selection (for e.g. "stock picking") and those performing manager selection (i.e. multi-manager / MPP models), rather than a differentiation based on the type of legal construct or business model used to construct the resulting investment portfolios.

Another helpful perspective was that the complexity of investment management activities performed often follows the life of an FSP, with services becoming more complex as the scale and level of sophistication of the business increases. Accordingly, although the commentator was in agreement with a degree of sub-categorisation, they argued that the sub-categorisation should not be too granular, as this would hinder the natural evolution of these businesses. A related argument against overly granular sub-categorisation was to point out that the same investment manager can provide services of different levels of complexity for different customers and for different purposes, and the regulatory framework should therefore be flexible enough to recognise this.

Other noteworthy views included the following:

- It was correctly highlighted that the FSCA's proposed categorisation and activity descriptions did not clearly provide for alternative investment management approaches such as private equity and hedge fund management. It was suggested that these activities may require separate

focus.
- Views differed on whether “traditional” investment management warranted a separate licence and competency category from MPPs, or whether these providers require similar skills.
- A number of commentators argued that no distinction for licensing and competency purposes was required between MPPs and managers of 3rd party co-branded portfolios, as both business models entail the same types of activities and skills, could operate similar portfolio structures, and posed similar risks of conflicts of interest and conduct risk.
- One association proposed that a distinction is required between actual 3rd party co-branding models, as formally provided for in the CIS regulatory framework, and less formally structured MPP offerings put together on a LISP and bearing an adviser’s brand, but not structured as a formal CIS portfolio (sometimes referred to as “broker funds”). Some commentators felt that in these models, although the adviser concerned also holds a FAIS Category II licence, no actual investment management is performed.
- Some commentators proposed that it was not necessary to create different licence categories for different types of discretionary investment management, but rather that fit and proper competency requirements should be tailored to the types of underlying products and / or activities performed. Some argued that the current FAIS fit and proper framework already implicitly makes this type of distinction - for example by having different competency requirements for services related to securities (thus applying to “stock pickers”) as compared to for services relating to participatory interests in CISs (applying to MPPS who only structure portfolios comprising underlying CISs).

2.2.2. The FSCA’s updated position

The FSCA remains of the view that the current “one size fits all” scope of the FAIS Category II licence is too broad to adequately and proportionally deal with the range of investment management services in the market, and that a degree of sub-categorisation of these activities is needed. We believe that this sub-categorisation is required both at actual licensing and at fit and proper requirement level. We also agree in principle with comments that any sub-categorisation should be activity-based, not based on differences in legal construct, product “wrapper” or business model, and that the sub-categorisation should not be so granular as to unduly inhibit flexibility and business development.

The FSCA now proposes that the licensed activity of discretionary investment management be broken down into three sub-activities for licensing purposes:
- Asset management: Discretionary investment management comprising asset selection (including asset class selection);
- Multi-management: Discretionary investment management comprising manager selection (including management style and asset class selection); and
- Alternative investment management: To include hedge fund management, private equity management, and potentially other alternative investment strategies. This category would in effect be an appropriately expanded version of the current FAIS Category IIA licence category.

Each of these sub-activities will need to be clearly defined in the regulatory instruments concerned, and suggestions are invited on appropriate definitions.

The proposed licensing framework would require any entity intending to perform investment management to apply for a licence for discretionary investment management and, as part of that licensing process, to apply for authorisation to perform one or more of the above-mentioned three sub-activities. We confirm that a licensed discretionary investment manager may perform any combination of the three sub-activities, subject to meeting the applicable fit and proper and other licensing requirements for that sub-activity.

New questions for stakeholder input:

Q3. Please provide your views on the proposal to split the activity of discretionary investment management into three sub-activities of asset management, multi-management and alternative investment management.

Q4. Do you have any suggestions for appropriate definitions of each of these sub-activities?

2.3. Fit and proper standards for investment management

2.3.1. Summary of inputs on the 2018 Investments Document

Differences in opinion on the need for differentiated fit and proper requirements for different forms of investment management were aligned with the different views on whether sub-categorisation of investment activities is required. In particular, views differed on whether the current FAIS fit and proper competency requirements for Category II FSPs were adequate or whether they needed strengthening for some or all types of investment management. Some argued that the current requirements are adequate and appropriate, while others felt strongly that the current requirements were too lenient.

Some commentators suggested that any differentiation of fit and proper requirements should focus not only on competence and experience requirements, but also consider differentiated operational requirements.

As noted in paragraph 2.2.1, an argument was made that the current FAIS fit and proper framework already implicitly differentiates between different types of investment management by imposing different competency requirements for different underlying product classes[4]. A specific concern was raised in relation to the current requirements for Category IIA FSPs, highlighting the risk of regulatory arbitrage between the Category II and Category IIA competency requirements.

A number of commentators also urged the FSCA to extend equivalent fit and proper requirements to those for investment managers to authorised users in the financial markets space (stockbrokers), arguing that their activities pose similar risks to investors.

2.3.2. The FSCA's updated position

It follows from the updated proposal that the licensing framework for investment managers should distinguish between asset management, multi-management and alternative investment management, that the fit and proper requirements will need to align to these sub-categories.

The FSCA's current thinking is that the experience and "class of business" training requirements, in particular, will need to be tailored to the three proposed sub-activities. We also invite input on the extent to which all other elements of the current fit and proper framework for Category II FSPs – including operational, qualification, product specific training and CPD requirements – may need to differentiate between the sub-activities[5].

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[4] See for example the different subcategories under the "class of business" training requirements for the Investments class.

[5] See specific questions in the attached Stakeholder Feedback Template.

The FSCA recognises that there will inevitably be a degree of overlap between the competency requirements for each sub-activity and that the skills and knowledge bases for the three sub-activities are by no means mutually exclusive. We therefore envisage a competency framework comprising a set of “core” requirements that will need to be met by all discretionary investment managers, complemented by additional sets of more focused requirements for each selected sub-activity – viz. asset management, multi-management and alternative investment management – designed to address skills and other requirements specific to that sub-activity.

Suggestions on how to reduce the risk of any current regulatory arbitrage between requirements for different licence categories are also welcome. In this regard, the FSCA will consider a requirement that an investment manager may not adopt investment strategies (such as gearing) that are typical of alternative investments, unless they are licensed for the alternative investment strategy sub-activity.

Note that the question of “levelling the regulatory playing field” between investment managers and investment advisers on the one hand, and authorised users of exchanges providing comparable services to investors on the other, is under review as part of broader policy discussions around the extent to which various provision of the future COFI Act should apply to such users.

New questions for stakeholder input:

Q5. Please provide your views on appropriate fit and proper requirements for each of the proposed sub-activities (asset management; multi-management; alternative investment management) in relation to:
(a) Operational requirements
(b) Minimum qualifications
(c) Minimum experience
(d) Class of business training
(e) Product specific training
(f) Continuous professional development.
Please indicate in what respects (if at all) the above requirements should differ for each sub-activity and to what extent they should differ from the existing competency requirements for FAIS Category II or IIA FSPs.

Q6. Which competency requirements, if any, do you believe should apply equally to all three sub-activities?

Q7. Do you believe there is currently scope for arbitrage between the fit and proper requirements for different licence categories in the investments sector and, if so, do you have any suggestions on how this could be resolved?

2.4. “Mandates for convenience”

2.4.1. Summary of inputs on the 2018 Investments Document

The 2018 Investments Document proposals regarding “mandates for convenience” enjoyed the greatest degree of support from commentators, with a significant majority agreeing that holders of these types of mandates should not be required to hold a discretionary investment management licence, and should be subject to a less rigorous regulatory framework than the current FAIS Category II requirements. Most commentators agreed that this would help to reduce the number of Category II licences that are held by or applied for by entities not performing true discretionary investment management. Some were of the view that current holders of Category II licences would

retain them, but that a more lenient dispensation for “mandates for convenience” would reduce the number of new Category II applicants. Others believed that a number of current Category II licence holders would in fact relinquish their licences to reduce compliance costs if they no longer required the licence.

Views differed somewhat on whether the current FAIS Category I fit and proper competency requirements were sufficient for these types of mandates, or whether additional competency requirements were required. Most stakeholders agreed that, regardless of whether these mandates require specific competency requirements, it would be important to ensure adequate governance and controls.

Most commentators who supported this dispensation agreed that this type of mandate was incidental to the provision of investment advice and that no separate fee should therefore be payable over and above the advice fee concerned. A limited number argued that operating such a mandate was an additional service to investors and should warrant an additional fee. Those opposed to an additional fee argued that this mechanism is in fact a cost saving to the adviser, not an additional service to the investor.

It was highlighted that it would be essential to clearly and carefully define the scope of activities that could be performed under these “mandates for convenience” to ensure that a less rigorous dispensation does not allow for regulatory arbitrage by allowing Category I advisers to perform *de facto* investment management without having to meet Category II requirements.

A suggestions was received that this dispensation should also permit switching between CIS portfolios operated by different investment managers, provided the portfolios concerned have similar mandates or fall under the same CIS fund category.

2.4.2. The FSCA’s updated position

The FSCA proposes to create and define a specific regulated activity for what the 2018 Investments Document described as operating a “mandates held mainly for convenience”.

General criteria

We remain of the view that this dispensation should be subject to the following criteria as set out in the 2018 Investments Document:

- Intermediaries holding these mandates are not regarded as exercising investment discretion but rather as holding a more limited authority to perform specified services under a written “standing authorisation” from a customer, without having to obtain the customer’s separate written instruction on each such occasion;

- The intermediary is not regarded and may not describe itself as an investment manager (unless they also in fact hold an investment management licence).

In addition, in order to limit the scope and potential risks of this service, the dispensation will be limited to mandates granted **by retail investors**. Portfolio rebalancing and similar activities for non-retail customers, which are a potentially complex exercise, will therefore continue to require a full discretionary investment management licence. The FSCA recognise that this will require a definition of “retail investor”. Our proposal is that this dispensation should initially apply in respect of investors who are natural persons only and, assuming that the COFI Act will in due course include a broader definition of “retail customer” that includes small businesses, the scope of this dispensation can be correspondingly expanded when that Act comes into operation.

Terminology

The FSCA invites suggestions on an appropriate naming convention for this type of mandate. Options we have considered include "standing portfolio adjustment authorisation"; "limited investment administration mandate"; "defined investment execution mandate" – or combinations of this terminology – but other suggestions are welcome.

Scope of the mandate

The FSCA fully agrees that a clear definition for the types of services that may be provided under this type of mandate / authorisation, that clearly sets out its limitations, is essential. It is important to avoid the risk of regulatory arbitrage whereby a Category I adviser purports to use this dispensation to de facto perform discretionary activities (see the discussion under paragraph 2.1.2 regarding potential regulatory arbitrage between advice and discretionary investment management).

In the 2018 Investments Document we stated that "transactions to be executed under such an authorisation would be limited to those required to rebalance the client's portfolio - at certain pre-agreed periods of time - back to the percentage fund exposures and / or asset allocation (in the existing selected portfolios / underlying assets) that the client originally agreed to, or to place additional investments into the same portfolios that the client originally agreed to". This remains the FSCA's position, and we now invite specific input as to how such a mandate should be expressed.

We are considering the feasibility of prescribing a standard mandate template – possibly with a short "menu" of pre-defined types of transactions that the customer could elect to authorise - to mitigate the risk of "scope creep" for these mandates.

The FSCA has also considered the suggestion that this dispensation should be extended to permit switching between CIS portfolios operated by different investment managers, provided the portfolios concerned have similar mandates or fall under the same CIS fund category. Our concern with this proposal is that it does entail the exercise of actual discretion by the Category I adviser as to the selection of investment managers, as opposed to mere ongoing alignment with a previously agreed investment solution, and should therefore fall within the regulatory framework proposed for the discretionary activity of "multi-management". We are also concerned that expanding the mandate in this way increases the risk of conflict of interests, where switches between funds could be influenced by the adviser's relationship with the CIS management company and / or investment managers concerned, rather than solely motivated by the investor's needs. The ability to make such switch decisions without prior customer consent could also increase the risk that the investor does not receive the level of advice that would otherwise be expected from a Category I FSP before recommending such a change. The FSCA is therefore not in favour of extending the "convenience" mandate to such switches. .

Fit and proper requirements and other conduct standards

The FSCA's current thinking is that we will not require additional fit and proper requirements for holders of "mandates for convenience" over and above the requirements that the holder will in any event need to meet in their capacity as a Category I adviser in relation to the types of investments subject to the mandate. Note that this means that a "mandate for convenience" may only be held by an FSP that is licensed under Category I for the provision of advice in relation to the investment products concerned. It also follows that any individual representative of the FSP that will be implementing the mandate must meet all applicable fit and proper competency requirements.

Aside from fit and proper requirements, these mandate holders will be subject to specific governance requirements and other conduct standards relating to oversight by management and key individuals, mandate control, customer communication and disclosure, record keeping, and regulatory reporting.

We will also consider imposing appropriate oversight obligations, where applicable, on CIS management companies and / or LISP platforms acting on the instructions of these mandate holders – for example requiring them to verify that the mandate is in fact in place before effecting the transactions concerned.

Remuneration

The FSCA remains of the view that the Category I adviser concerned may not receive a fee for this service over and above an advice fee negotiated with and agreed to by the customer. This is in line with our view that actions taken under a "mandate for convenience" are ancillary to the investment advice provided.

Licensing and authorisation approach

Holding and acting on a "mandate for convenience" will not require a separate licence category or authorisation by the FSCA. Any FSP licensed under the FAIS Act as a Category I FSP (for advice in relation to the applicable product categories) will be permitted to perform this activity. They will however be required to notify the FSCA that they intend to perform this activity, in order to enable the FSCA to identify FSPs performing this activity so that we can supervise compliance with relevant requirements[6]. Note that the FSCA, using its normal enforcement powers, will be able to direct an FSP or representative to cease these activities, or impose appropriate sanctions, in the event of contravention of standards regarding these mandates.

Where the Category I FSP concerned does in fact also hold a discretionary investment management licence (currently a Category II or IIA licence), separate notification to the FSCA of the intended performance of this activity is not required. The performance of the types of services envisaged under this mandate will in that case be a function of the applicable discretionary mandate already in existence.

[6] This notification approach will therefore be similar to the approach currently in place for Category I advice FSPs that provide "automated advice".

New questions for stakeholder input:

Q8.Do you agree that the dispensation for "mandates for convenience" should be restricted to retail investors? If you believe it should not be so restricted, please provide examples of where such a mandate would be appropriate in the non-retail space.

Q9. Please provide suggestions on an appropriate term to denote a "mandate for convenience".

Q10. Please describe the specific types of transactions you believe are appropriate to be authorised under a "mandate for convenience", recognising the need to avoid inappropriate arbitrage between these mandates and discretionary investment management mandates.

Q11. Do you support the proposal for a prescribed standard template with a "menu" of pre-defined permissible transactions for these "mandates for convenience"?

Q12. Do you foresee any unintended consequences of the FSCA's view that "mandates for convenience" should not be extended to include switches between similar CIS portfolios?

Q13. Do you foresee any unintended consequences of imposing no additional fit and proper competency requirements for holding a "mandate for convenience" over and above the applicable requirements for a FAIS Category I (advice) licence?

Q14. Please provide suggestions for appropriate governance, record keeping, disclosure and / or regulatory reporting requirements to be imposed on the holder of a "mandate for convenience".

Q15. Do you agree that CIS management companies and LISP platforms should be required to verify that a "mandate for convenience" is in place before acting on the instruction of such a mandate holder? If not, why not?

Section 3: Categorising investment advisers within an RDR framework

As explained in previous RDR communications, the adviser categorisation model to be adopted under the RDR framework distinguishes between:

- Product supplier agents (PSAs), who operate on the licence of a product supplier and may provide advice on the products of that product supplier (and other product suppliers in its group) only; and
- Registered financial advisers (RFAs), who will be separately licensed in their own right to provide advice on whatever products their licence permits, and are not limited to offering the products of any particular product supplier/s.

This two-tier adviser categorisation model also means that the same entity will not be permitted to operate as both a PSA and an RFA. A clear choice between the two categories of adviser will be required.

The 2018 Investments Document asked a number of questions regarding the implications of this adviser categorisation approach for the investments sector, dealt with in potential Measures 7 to 14 and questions 6 to 13 in the 2018 document. This Section summarises the responses received and provides an update on the FSCA's thinking in this regard.

This Section should be read together with the FSCA's paper titled *RDR: Discussion Document on Categorisation of Financial Advisers and Related Matters*, also published in December 2019.

Questions for stakeholder input in the 2018 Investments Document:

Q6. Which of option (a) or (b) under Measure 7 above do you believe would be most appropriate to provide for the possibility of an investment adviser acting as the PSA of an investment manager or LISP? If you do not believe that either option is appropriate or necessary, please explain why and let us know if you have any alternative suggestions. In particular, please indicate whether or not you believe it is necessary to provide for the situation where an investment adviser could act as the PSA of a LISP and why you hold this view.

Q7. Would your answer to Question 5 above in relation to allowing an investment manager to appoint a PSA be the same in relation to allowing an MPP to appoint a PSA as discussed under Measure 8? If not, why not?

Q8. Do you agree that all of the distribution model options described in Measure 9 should be available to all investment managers and MPPs and do you agree with the descriptions of each model? If not, why not?

Q9. Please provide your views on the correctness, feasibility and likely effectiveness of each of the possible provisions set out under Measure 10 to regulate CIS white label arrangements. Please let us know if you have any alternative suggestions.

Q10. Do you agree that a CIS management company should be able to appoint a PSA to provide advice on its portfolios? If not, why not? If yes, do you agree with the above description of the implications of such an arrangement?

Q11. Which of options (a) to (c) under Measure 12 above do you believe would be most appropriate to deal with the implications for PSAs of using a LISP platform outside their group? If you do not believe that any of these options is appropriate, please explain why and let us know if you have any alternative suggestions.

Q12. Do you agree that the details under Measure 13 correctly describe the adviser categorisation implications of acting as a third party co-branding investment manager as well as holding another type of discretionary mandate? If not, why not? Are there any additional implications we have not identified that might influence the adviser categorisation in these business models?

Q13. Do you agree that an appropriate due diligence review should be required in all of the scenarios set out under Measure 14? Are there additional arrangements requiring due diligence that we have not mentioned? Do you have any suggestions as to what such due diligence requirements should comprise?

3.1. Is there a need for a "tied" advice / product supplier agent (PSA) model in the investments sector and how would it work?

3.1.1. Summary of inputs on the 2018 Investments Document

Commentator views were divided on whether there is a demand for "tied" advice models in the investment space, and whether strict application of the two-tier PSA / RFA categorisation is feasible for investment advice.

Some commentators felt that, particularly in light of the "open architecture" nature of investment offerings and the need for flexibility in tailoring investment solutions to customer needs, there would be very little demand for an advice model which limited advice to the offerings of a single supplier or group. The opposite view was that, where an investment manager has developed its own "in house" investment solutions and has confidence that these meet an adequate spread of customer needs, an advice model restricted to recommending such solutions should be available. It was also pointed out that "tied" advice models already exist in a number of financial groups, where for example the tied advisers of an insurer in the group also offered the investment products of CIS management companies and / or LISP platforms in the group.

Some argued that it should be open to financial groups to include both tied and non-tied distribution channels (i.e. both PSA and RFA models) in the same group through separate legal entities, while others argued that the PSA / RFA split at entity level would not be feasible and that the same entity should be permitted to offer tied advice for some products / solution types and non-tied advice for others. Some took this further, arguing that different individual advisers in the same entity should be able to be tied and others non-tied.

It was generally recognised that the tied advice model would be most likely to be adopted in so-called "vertically integrated" models, although some commentators felt that these models made up a relatively small proportion of the investments industry and it was therefore not necessary to introduce the complexity of a tied advice framework for these models.

Most stakeholders who supported the need for a tied investment advice model highlighted that this should nevertheless allow adequate flexibility in relation to the use of "open architecture" investment platforms and portfolio construction.

Clarity was requested on whether, where the advisers in a group predominantly recommend their in-house solutions, but are not contractually precluded from also recommending external solutions, this would mean that the advisers have to be categorised as PSAs.

3.1.2. The FSCA's updated position

The FSCA believes that there is, on balance, a need to provide for a tied / PSA advice model in the investments sector, where industry players can if they so wish establish distribution models that limit advisers to recommending "in-house" or "in-group" investment offerings. This will however require careful delineation of what constitutes such a group offering, with due regard to the "open architecture" flexibility of investment structures. (See section 3.2 below).

The establishment of a tied advice model will entail an explicit contractual limitation on the advisers concerned, disallowing them from providing advice on any products or services external to the group. Absent such a contractual limitation, the advice channel will be categorised as an RFA.

The fact that a particular RFA adviser or advice channel primarily recommends the offerings of a particular product or service provider, including in-group offerings, will therefore not automatically preclude it from being categorised as an RFA, nor will it necessarily trigger "re-classification" as a PSA channel. The RFA will however need to be able to satisfy the FSCA that there are no incentives in place that create the risk of biased or conflicted advice. For group structures, we will require appropriate controls to be in place to ensure that advisers are indeed free to recommend external offerings where the in-group offerings are not appropriate to an investor's needs. The FSCA will also monitor the spread of products or services recommended by RFAs, and require the RFA itself to monitor the recommendations of its individual advisers, to mitigate the risks of such conflicts. This scrutiny will be proportionally closer in vertically integrated group structures, given the increased risk of conflicts of interest in such models. If the FSCA observes that an RFA channel in a group is in practice exclusively or nearly exclusively recommending in-group offerings only, we are likely to interrogate management as to whether the channel is appropriately structured as an RFA or

whether a PSA structure would be more appropriate.

We also confirm the following:[7]

- It will be permissible for the same group of companies[8] to operate both tied and non-tied (PSA and RFA) advice channels, provided these are operated through separate legal entities. Group level governance controls will need to be in place to mitigate the risk of conflicts of interest arising in such business models.
- It will not be permissible for the same entity to offer tied advice for some products / solution types and non-tied advice for others; nor for different individual advisers in the same entity to provide tied advice and others to provide non-tied advice. This does not preclude an RFA firm from allowing some advisers to offer advice on a broader range of products and services than others, depending for example on their competence and experience levels or the customer groups they serve, provided that such restrictions do not limit the adviser to in-group offerings only.

3.2. Defining "group" products and services for determining the scope of advice for a tied (PSA) investment adviser

3.2.1. Summary of inputs on the 2018 Investments Document

In the RDR framework, the concept of a PSA entails an adviser acting as the agent of a product supplier, where that product supplier itself is licensed to provide advice and the PSA therefore operates through the product supplier's advice licence. In the current FAIS framework, the product supplier would be required to hold a FAIS Category I FSP licence for advice, and the individual PSAs would be representatives of that product supplier FSP. In the investments sector, although CIS management companies are regarded as product suppliers, discretionary investment managers and LISP platforms (administrative FSPs) are regarded as performing specialised intermediary services, under FAIS Category II / IIA and Category III licences respectively.

The 2018 Investments Document therefore noted that in order to provide for a tied advice model in relation to investment management services and / or LISP platform services, it would be necessary to deviate from the base RDR model in one of two ways: Either (a) by providing that a PSA could act as an agent of either a product supplier or a service provider; or (b) by regarding investment managers and / or LISPs as "product suppliers". The significant majority of stakeholders preferred option (a), viewing it as less disruptive to the current FAIS framework, with very limited support for option (b).

Most commentators agreed that it should be possible for an adviser to be appointed as the PSA of a CIS management company, and that this was already legally possible as a CIS management company is clearly a product supplier. There were however opposing views, arguing either that it should not be possible for a PSA to act for a CIS management company, or that there would be little demand for this, as CIS management companies are typically not equipped to oversee advice models and do not regard advice as part of their value proposition. In response to whether it would be necessary to provide for PSAs to be appointed by LISP platforms, the majority (but not unanimous) view was that this would not be appropriate as these platforms perform a purely administrative function in relation to the investments managed on their platforms, and that it is these investments that are the subject of advice rather than the administrative services of the LISP itself.

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[7] Please also see the *RDR Discussion Document on Categorisation of Financial Advisers and Related Matters*, also published in December 2019, which provides further detail on a number of the matters discussed in this section.

[8] The *RDR Discussion Document on Categorisation of Financial Advisers and Related Matters* proposes a definition of "group of companies" aligned to the corresponding definition in the Companies Act.

The point was made that although the choice of LISP can have service delivery and efficiency implications for customers, it does not in itself have significant impact on investment returns and that the focus of RDR should therefore be on the selection of investment portfolios and / or investment managers, rather than the selection of a LISP platform.

The majority of stakeholders felt that, if tied advice relationships were to be established in the investments space, these would most likely be between advisers and discretionary investment managers in their groups, rather than between advisers and CIS management companies or between advisers and LISPs.

One of the most contentious issues raised in the 2018 Investments Document was the question of whether, and to what extent, a PSA within a financial services group should be permitted to provide advice on investment offerings administered on a LISP platform outside of the group. The FSCA had requested views on three options: (a) Disallow the PSA channel from advising on offerings on any LISP outside the home group. This would also mean that PSA channels in a group that did not have its own LISP platform in the group, would not be able to offer LISP based portfolios at all; (b) Allow the PSA channel to advise on offerings on an external LISP, but only where the LISP does not have its own LISP platform and where the investment offerings on the external LISP are structured by an investment manager in the home group; Or (c), the same option as option (b), but with the further limitation that use of an external LISP will only be permitted in groups below a certain size and scale.

Views on all three of these options diverged widely. The majority of commentators viewed option (a) as unnecessarily restrictive and unfair to groups that did not have their own LISPs, and objected to option (c) as unduly interfering in business model choices by seeking to “force” larger groups to establish LISPs if they wish to run tied advice models. Option (b) enjoyed the greatest level of general support, although a number of concerns were raised regarding some or all of the conditions attached to this option.

The argument was put forward that, because a LISP platform is purely an administrator (see above), limitations on the use of external LISPs are unnecessary. Although a number of commentators supported limiting PSA advice to products on the in-group LISP for groups that do have a LISP, others argued that even in this case PSAs should be permitted to offer products on external LISPs too. A valid point was also raised that it would be inconsistent to allow a PSA in a group that does have a LISP to recommend investments managed by non-group investment managers if these are administered on the in-group LISP, but then to limit PSAs of groups that do not have a LISP only to investments on an external LISP that are structured by an in-group investment manager.

The important point was raised that any change in the adviser categorisation model would need to clarify how existing investments and contractual relationships between advisers, customers and other entities in the value chain (so-called “legacy” arrangements) would be impacted.

3.2.2. The FSCA’s updated position

Allowing investment managers to appoint “tied” advisers

The FSCA believes that the regulatory framework should allow a discretionary investment manager – in any of the three sub-categories of investment management proposed in this document – to appoint “tied” / PSA advisers if it so wishes. We agree with the view of the majority of stakeholders that the most appropriate way to provide for this will be to extend the scope of the PSA model to allow tied advisers to be appointed by either product suppliers or service providers (specifically, discretionary investment managers). This would also require a change to the current RDR term of

"product supplier agent", which would not be an accurate description of this relationship.[9]

It follows that a tied adviser / PSA will therefore, in addition to being permitted to recommend financial products offered by a product supplier in its home group (such as a bank, insurer or CIS management company), also be permitted to recommend the entering into of a discretionary investment mandate with a discretionary investment manager that is also a member of that group. Note that the focus here is on the entity *in whose favour the actual discretionary mandate is signed* by the customer concerned – it is that entity which needs to be a member of the group concerned in order for the recommendation concerned to fall within the scope of tied / PSA advice. Note that, where the investment is directly into a CIS portfolio, the customer concerned does not sign a discretionary investment mandate. Accordingly, in the case of CIS portfolios, the PSA will be permitted to recommend any CIS portfolio offered by a CIS management company within the group, regardless of whether the underlying investment manager/s of the CIS portfolio is also a member of the group.

Where an adviser acts as the tied adviser / PSA of a discretionary investment manager, that investment manager will therefore be fully accountable for the advice provided and for ensuring compliance with all applicable legislative requirements related to that advice.

PSAs of CIS management companies

The FSCA confirms that it will also be permissible for a CIS management company to appoint "tied" / PSA advisers if it so wishes. As CIS management companies are already product suppliers for FAIS purposes, this will not require any structural change to the FAIS licensing framework. As pointed out in the 2018 Investments Document, this it will however be necessary to amend the current FAIS exemption of CIS management companies, to confirm that the management company and the adviser will indeed be subject to relevant FAIS obligations relating to the provision of advice in such cases. It will also be necessary to amend CIS legislation to remove "advice" from being included as part of the scope of the CIS management company's ordinary administrative activities.

Use of LISPs by tied advisers

The FSCA agrees in principle with stakeholders who argued that the services of a LISP platform (Administrative / Category III FSP) are purely administrative in nature, and that the identity of the LISP should therefore not be a material factor in determining which investment products or investment management services a PSA may recommend. We therefore now propose that, *where there is no LISP platform inside a group*, PSAs will be permitted to recommend the following types of investment offerings:

- Investments directly into CIS portfolios offered by a CIS management company that is a member of the group;
- Other investment products issued by other product suppliers in the group – such as bank deposits or insurance policy "wrapped" products of a bank or insurer in the group, regardless whether any investments underlying such a products are administered by an investment manager inside the group or not;
- Investments directly into 3rd party co-branded CIS portfolios managed by an investment manager that is a member of the group, regardless whether the CIS management company is a member of the group or not;
- Offerings administered on a LISP but not in the form of investment directly in a "product wrapper" such as an insurance policy or a CIS portfolio, where the investor signs a discretionary investment mandate with a discretionary investment manager that is a member of the group, regardless of which LISP or LISPs the offering/s may be administered on. In the case of a multi-managed investment, provided the discretionary investment manager with whom the

[9] See proposals regarding terminology to describe different categories of advisers in the *RDR Discussion Document on Adviser Categorisation and Related Matters*, also published in December 2019.

mandate is signed is a member of the group, it will not be necessary for any underlying investment managers to also be members of the group;
- Other investments (for example segregated portfolios) entailing the signature of a discretionary investment mandate with an investment manager that is a member of the group.

In view of the divergent feedback received on the extent to which PSAs should be able to recommend products administered on LISPs outside the group in cases *where there is a LISP platform inside the group*, we invite feedback on which of the following approaches is preferable in relation to LISP administered investments:

- *Option1*: Group PSAs to have the same product range as set out above for PSAs of groups that do not have a LISP; or
- *Option 2:* As for Option 1, except that offerings administered on a LISP but not in the form of investment directly in a "product wrapper", where the investor signs a discretionary investment mandate with a discretionary investment manager that is a member of the group, must be administered on the in-group LISP. As for groups without a LISP, in the case of a multi-managed investment, provided the discretionary investment manager with whom the mandate is signed is a member of the group; it will not be necessary for any underlying investment managers to also be members of the group.

Importantly, the approach that the choice of LISP is not a key factor in adviser categorisation, presupposes that the role of LISPs in the investments value chain is indeed purely administrative, and does not stray into influencing actual investment management decisions and investment advice. Our proposals regarding choice of LISP platforms therefore need to be complemented by our other RDR proposals regarding "clean pricing" of LISP services and removal of rebates[10] and more broadly mitigating conflicts of interest in the investments value chain. These proposals will be consulted on in more detail in due course.

PSAs of LISPs

If, as discussed above, if it is accepted that a LISP's role is purely administrative, the FSCA believes it follows that there should be no need for a LISP platform to be able to appoint its own PSAs to provide advice on its behalf – i.e. to recommend the use of the LISP's administrative services. We invite comment however on whether there are in practice business models where it would be appropriate for a LISP to appoint its own PSAs. (Note that this would imply that the LISP itself would need an advice licence in addition to its platform administration licence – i.e. both a Category I FSP licence and a Category III FSP licence.)

General

In summary: The combined effect of the FSCA's above thinking regarding the scope of "group" products and services for purposes of PSA limitations, is that a PSA will be limited to advising on either "product wrappers" offered by product suppliers in the group or, where the offering is not in the form of such a product wrapper, recommending the granting of a discretionary investment mandate to an investment manager in the group. Other than possibly limiting PSAs that have a LISP platform in their group to using such platform for non-"wrapper" offerings, the choice of LISP platform on which such offerings may be administered will not be restricted.

Note however that in all cases the use of LISP platforms and investment managers outside the PSA group will be subject to applicable due diligence processes, as discussed in the 2018 Investments Document.

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[10] See Proposal YY in the initial RDR paper.

New questions for stakeholder input:

Q16. Please provide your views on the FSCA's proposed approach to allowing investment managers to appoint "tied" advisers.

Q17. Please provide your views on the FSCA's proposed approach to PSA's of CIS management companies.

Q18. Please provide your views on the FSCA's proposed approach to the use of LISPs by tied advisers where there is no LISP platform in the group.

Q19. Please let us know whether you prefer option (1) or (2) above in respect of the use of LISPs by tied advisers where there is a LISP platform in the group. Please explain why you prefer this option.

Q20. Please describe any business models you are aware of where a LISP platform's role goes beyond purely administrative functions and could potentially influence investment management decisions or investment advice.

Q21. Please describe any business models you are aware of where it would be necessary or appropriate for a LISP platform to be able to appoint its own tied advisers.

3.3. Third party co-branded CIS models

3.3.1. Summary of inputs on the 2018 Investments Document

The 2018 Investments Document proposed various measures to clarify the relationships between CIS management companies and discretionary investment managers in relation to third party co-branded CIS portfolios.

Although most stakeholders agreed that the CIS management company should be responsible for the investment management activities of the 3rd party investment manager, there were some dissenting views. Some commentators argued that CIS management companies operating 3rd party co-branding models typically specialise in investment administration, but do not have the skills and capacity to be accountable for the actual investment management activities (asset and manager selection). Accordingly, these commentators felt that although the CIS management company should be accountable for overseeing the administrative and governance related compliance of the 3rd party investment manager, it should not be accountable for the actual investment decisions, portfolio construction activities and resulting investment performance of the 3rd party. A few commentators took this argument further, raising a concern that if the CIS management company were to be held fully accountable for the actual investment decisions of the 3rd party, this would compromise the value proposition of the 3rd party investment managers using this business model, and could result in the CIS management company "second guessing" the 3rd party investment manager's strategies. It was also argued that the FSCA's approach would result in greater levels of vertical integration and lack of competition in the investments sector, adding additional fee layers and driving up costs to investors.

Among those who supported holding the CIS manager accountable for the 3rd party's investment management activities, some made the additional point that this should not allow the 3rd party itself to abdicate its own regulatory responsibilities as an investment manager.
There was general support for the proposal that, notwithstanding its accountability for the 3rd party's investment manager activities, the CIS management company should not be accountable for the

advice provided by the 3rd party investment manager or its associates (unless these also happen to be PSAs of the CIS management company or its group).

Views were divided on whether any advice provided by a 3rd party investment manager operating a co-branded CIS portfolio (where the 3rd party also holds an advice licence) may describe itself as "independent".

Views were also sharply divergent on the extent to which the CIS management company in these business models should take responsibility for the services provided by a LISP, where the co-branded portfolio concerned is offered through one or more LISP platforms. Some commentators agreed with the FSCA proposal that the CIS management company should have the same responsibility in relation to the LISP in these models as for any other (non co-branded) CIS portfolio it manages. Others felt that the FSCA's proposal was not consistent with the practicalities of LISP services. It was flagged that, although some degree of due diligence in relation to a LISP may be appropriate (see section 3.4 below), the LISP does not act as the agent of the CIS management company whose portfolios are placed on its platform, and the CIS management company's responsibility for the LISP's services should therefore not be overstated. It was pointed out by some that the CIS management company will often not have access to data regarding LISP administered investments at adviser level – for e.g. the CIS management company will not know which investment advisers support its portfolios through the LISP – and that this reality must be recognised in setting expectations for oversight of LISPs.

An additional concern was raised regarding business models that are not formally structured as 3rd party co-branded CIS portfolios, but are structured as less formal "co-named broker funds", where CIS management companies allow financial advisers to co-brand portfolios without performing actual investment management activities in relation to the offerings concerned.

3.3.2. The FSCA's updated position

CIS management company oversight of the 3rd party's investment management activities

The FSCA remains strongly of the view that a CIS management company that enters into third party co-branding arrangements retains full accountability for the third party's outsourced investment management activities. In addition to the views set out in the 2018 Investments Document, the FSCA's rationale for this approach is illustrated by and expanded on in the reasons provided in our recent administrative penalty decision against MET Collective Investments (Pty) Ltd.[11]

The FSCA is therefore not persuaded by the concerns raised regarding the CIS management company unduly "second guessing" the 3rd party investment manager or undermining its role. We are not aware in our supervisory experience of any actual examples of such "second guessing", over and above compliance and risk management oversight by the CIS management company, actually taking place. Our expectation would be that the CIS management company's oversight should be of a similar level to that over investment managers managing non co-branded CIS portfolios.

Robust CIS management company oversight is a necessary precondition for outsourced 3rd party co-branded portfolios and the MET Collective Investments case vividly illustrates the risks of an oversight failure. Where an entity wishes to manage an approved CIS portfolio but is not comfortable with the level of CIS management company oversight required in the 3rd party co-branded model, the entity has no alternative but to apply for its own licence as a CIS management company.

[11] See FSCA Case number 11/2019.

The FSCA will however consider issuing regulatory guidance to clarify our expectations on the respective responsibilities of the CIS management company and the 3rd party investment manager in these models, should it become apparent that there is confusion in this regard.

Independence of advice in 3rd party co-branded arrangements

On the question whether advice provided by the 3rd party investment manager (where it is also licensed for advice) or members of its group may describe its advice as "independent", we confirm that the same prerequisites for this designation as set out in pending changes to the FAIS General Code of Conduct and in the *RDR Discussion Document on Adviser Categorisation and Related Matters*, will apply where the adviser operates as an RFA. The mere existence of the 3rd party co-branding arrangement will therefore not preclude the RFA adviser from describing itself as "independent", provided the other criteria for that designation apply. Note however that an adviser appointed as a PSA of the 3rd party investment manager or as a PSA in its group, will never be able to use the designation "independent".

Responsibility for use of LISPs in 3rd party co-branded models

Concerning the CIS management company's responsibility for the activities of a LISP on whose platform the 3rd party co-branded portfolio is administered, the FSCA remains of the view that the management company should have the same responsibilities as would apply where non co-branded CIS portfolios are offered through a LISP platform. We believe that the concern raised that the CIS management company may not have access to adviser level data is misplaced. Our proposal does not require oversight of the LISP's activities at adviser level, but rather oversight at portfolio level. A CIS management should always be aware of the fact that its portfolios, including 3rd party co-branded portfolios, are being administered on a LISP platform.

Further potential risks

Lastly, the FSCA will do further fact finding regarding the concern raised around so-called "co-named broker funds" that are not operated through formal 3rd party co-branding arrangements, to understand the nature, prevalence and potential conduct risks posed by any such practices. One potential option we are considering is to require a LISP to ensure that no such branding is allowed on its platform unless it has verified that the entity concerned is licensed as an investment manager (typically this would be as a "multi-manager") and does in fact hold and act on discretionary mandates in relation to the branded solution. A LISP would therefore be disallowed from permitting such branding by any entity that holds only a Category I licence, including where it holds a "mandate for convenience".

New questions for stakeholder input:

Q22. Please provide your views on the FSCA's proposed approach to when advice in relation to 3rd party co-branded portfolios may be described as "independent".

Q23. Please provide your views on the nature, prevalence and potential conduct risks of so-called "co-named broker funds" that are not operated as formal 3rd party co-branded CIS portfolios.

Q24. Do you agree that a LISP platform should be required to ensure that no branded portfolio is allowed on its platform unless it has verified that the entity concerned is licensed as an investment manager and does in fact hold and act on discretionary mandates in relation to the branded solution? If not, why not?

3.4. Due diligence responsibilities

3.4.1. Summary of inputs on the 2018 Investments Document

All commentators broadly agreed that an appropriate level of due diligence should be performed by players in the investment value chain before entering into relationships with one another or recommending their products and services to financial customers. Further clarity was however requested regarding the FSCA's expectations around the extent and outcomes of such due diligence investigations. A number of commentators argued that the same level of due diligence would not be appropriate as between all the types of entities involved and that a proportional approach should be applied, taking into account the capacity of the entity required to perform a due diligence. For example, a small financial advisory business should not be expected to perform the same level of due diligence on a large CIS investment manager, as a CIS management would be expected to perform on a LISP platform.

Other key points raised were:

- Prescribed due diligence requirements should be principles-based and flexible.
- The FSCA should consider alignment with other due diligence requirements in other regulatory frameworks, such as those for insurers.
- Entities required to perform a due diligence should be entitled to place reasonable reliance on the fact that the entity to be reviewed has been licensed by the FSCA.
- Entities should not be required to perform an additional due diligence where this has already been performed by another entity in its group.
- Concern was raised that the term "due diligence" implies that an extensive financial and operational reviews such as that used in large corporate finance transactions is required, and an alternative term should be considered.
- The scope of the required due diligence should be limited to factors relevant to the particular products and services to be used / recommended by the entity performing the due diligence.
- One commentator suggested that an entity required to perform a due diligence should be permitted to outsource the task to an appropriate expert, particularly where the first-mentioned entity may not have sufficient expertise in the other entity's activities. This was expanded to suggest that such expert reviews could, subject to agreed industry level criteria, then be made available to prospective customers more broadly – an approach analogous to a "roadworthy certificate".

3.4.2. The FSCA's updated position

The FSCA acknowledges that further clarity is required regarding expected levels of due diligence in different situations and will consult on more detailed proposals in due course, taking the above inputs into account. We agree with the view that due diligence requirements should be flexible and proportional. Although we agree that an entity required to perform a due diligence exercise should be able to place reasonable reliance on the fact that an entity has been licensed by the FSCA, we emphasise that due diligence cannot be reduced to a mere licence check.

New question for stakeholder input:

Q25. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding appropriate levels of due diligence between different entities in the investments value chain?

Section 4: Implications for remuneration and charging structures

This Section deals with matters raised under potential Measures 15 to 21 in the 2018 Investments Document, and responses to Questions 14 to 20 of that Document. As noted in Part A above, final proposals on a number of the matters dealt with in this Section 4 are to an extent dependent on the outcomes of our consultation on Sections 2 and 3. This Section therefore provides feedback at a more summarised level than the preceding Sections, and in the main indicates areas of further stakeholder engagement.

Questions for stakeholder input in the 2018 Investments Document:

Q14. Do you support the use of ASISA's EAC cost disclosure mechanism as proposed and do you have any suggestions as to how it could be applied or adapted to support the desired RDR outcomes regarding cost transparency in the investments sector?

Q15. Please provide your views on the questions raised under Measure 16 in relation to mitigating the risks of duplication of charges. Are there any other risks of inappropriate duplication of fees and charges in the investments sector that we should be considering?

Q16. Please provide your views on each of the possible regulatory responses noted under Measure 17 in relation to mitigating the risks of conflicted advice. Are there any other risks of conflicted advice in the investment sector that we should be considering?

Q17. Please provide your views on the correctness, feasibility and likely effectiveness of each of the possible provisions set out under Measure 18 in relation to facilitation and monitoring of fees and charges. In particular, do you agree that the provisions should extend beyond advice fees, and if so in what circumstances? Please let us know if you have any alternative suggestions.

Q18. Please provide your views on the appropriate remuneration model for automated advice services.

Q19. Please provide your views on the appropriate remuneration model for non-advised investment product sales. Inputs on the current extent and structure of such models will be appreciated.

Q20. Please provide your views on how best to mitigate the risk of conflicted exercise of discretion in the situation discussed under Measure 21. Inputs on the current extent of such models – i.e. where investment management fees are charged by both the model portfolio provider and the underlying investment manager/s - will be appreciated.

4.1. Cost disclosure

4.1.1. Summary of inputs on the 2018 Investments Document

Almost all commentators indicated in-principle support for using a cost disclosure model based on ASISA's Effective Annual Cost (EAC) disclosure mechanism for a broader range of investment offerings. It was pointed out however that the EAC mechanism was designed for specific purposes and would require some technical adjustment to be effectively applied to a broader range of products and business models.

Commentators highlighted that it would be important to ensure that the disclosure mechanism enabled visibility of the costs of all “layers” of entities and services in the applicable investment value chain and catered for all business models. It was argued that this will enable investors to make informed decisions and comparisons and to assess the “value add” of the different services charged for. The need for both simplicity and flexibility of the model was also flagged, with some concerns raised that the current EAC model is complex and difficult for ordinary customers to understand.

One commentator, who did not support the use of the EAC model, argued that it places undue emphasis on the cost element of an investment and disregards the actual quality of investment outcomes.

A number of suggestions were also made that a disclosure document similar to the prescribed Minimum Disclosure Documents required for CIS portfolios should apply to offerings outside of the formal CIS framework, such as model portfolios.

4.1.2. The FSCA’s updated position

Based on feedback received, the FSCA will engage with ASISA and other stakeholders to understand the extent to which the EAC model could be adapted as a broader investment cost disclosure mechanism, and the associated technical challenges. We fully agree that the disclosure model needs to enable investors to understand and compare the costs associated with every entity in the value chain, what services are being provided for that cost, who the recipient of any remuneration is, and what the impact of each item of cost will be on their investment return.

The FSCA also agrees that investment managers offering model portfolios and other non-CIS solutions should be required to provide disclosure documents similar to - and comparable with - CIS Minimum Disclosure Documents, and will consult further on how best to achieve this.

Also note the new requirement in the amended s.3A of the FAIS General Code of Conduct[12] requiring written customer consent to the amount, frequency, payment method and recipient of any fees (other than regulated commission and certain other regulated fees) including consent to the details of the services that are to be provided in exchange for the fees.

New question for stakeholder input: *Q26. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding our updated position on cost disclosure?*

[12] These amendments have been finalised after consultation and have been submitted to the National Treasury for onward submission to Parliament.

4.2. Mitigating the risk of duplication of charges

4.2.1. Summary of inputs on the 2018 Investments Document

Almost all commentators argued that the improved disclosure of all charges for all activities and players in the value chain was - in whole or in part - the most effective mitigation of duplicated fees and charges.

Additional risk mitigation measures suggested or highlighted by some commentators included:

- Implementation of RDR Proposal YY, in effect requiring "clean pricing" for LISP platform services and disallowing rebates.
- Implementation of the FSCA's proposal to extent the ASISA EAC cost disclosure mechanism to a broader range of offerings, covering all applicable costs and entities.
- Prescription of the types of fees that may be charged (including some suggestions that the level of fees should be capped) and associated disclosure obligations.
- Placing responsibility on the financial adviser concerned to ensure disclosure of all fees associated with all services and entities.
- A proposal to impose an investor "opt-in" every three years for the continuation of any ongoing fees, with the opt-in notification to be accompanied by full disclosure of the impact of each type of fees to date.
- Principle-based requirements that no fee should be chargeable without an actual demonstrable service provided; and that fees should be commensurate with the services provided (although some concerns were raised regarding the difficulty in determining what constitutes a "commensurate" fee).
- A requirement to provide a detailed fee comparison, including a comparison of the impact of fees, when investments are switched – including switches between business models (for example switches from existing CIS portfolios to model portfolios or 3rd party co-branded solutions).
- A requirement for CIS management companies and LISPs to approve, take responsibility for and benchmark investment management fees charged on offerings using their funds or platforms.
- A suggestion to clearly separate advice fees from other product or service fees, so that changes in other fees do not impact on the advice fee, thus reducing the risk of conflicted advice and increasing the likelihood of the adviser negotiating lower product and service fees.
- The FSCA to adopt an "exception management" supervision approach to charging practices.

A point was made that, provided all disclosure and conflict of interest management requirements were complied with, the FSCA should not interfere in commercial arrangements regarding allocation of costs across the investments value chain. Some commentators argued that competitive market forces, coupled with disclosure, are already imposing some constraints on charges. Others pointed out however that market forces are only effective in this regard if fee arrangements are entered into on an arms' length basis, which is not always the case.

4.2.2. The FSCA's updated position

Although the FSCA is in full agreement that enhanced disclosure is a significant mitigating factor in reducing the risk of inappropriate cost duplication, it cannot be relied on as the sole solution to conflicted and unjustified charging practices. Strengthened disclosure standards therefore need to be complemented by broader interventions aimed at reducing these risks, as discussed elsewhere in our RDR proposals. In this regard, we believe that all of the above stakeholder suggestions to mitigate the risk of inappropriate cost duplication are worth exploring. We will consult further on

these potential measures, together with our broader conflict of interest management frameworks.

We also point out the pending general remuneration principles being introduced through amendments to section 3A of the FAIS General Code of Conduct[13]. These principles are in summary that an FSP may only earn financial interests (other than regulated commissions) where the interest is reasonably commensurate with the service being rendered; it does not result in the provider being paid more than once for a similar service; any actual or potential conflicts of interest are effectively managed; and delivery of fair customer outcomes is not impeded.

New question for stakeholder input:

Q27. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding our updated position on mitigating the risk of duplication of charges?

4.3. Mitigating the risk of conflicted advice in vertically integrated models

4.3.1. Summary of inputs on the 2018 Investments Document

Measure 17 of the 2018 Investments Document invited comment on various possible measures to address the risk of conflicted advice in certain vertically integrated business models. These included proposals regarding: Ensuring the relevant relationships are clear through common branding, marketing and advertising material; requiring advice and investment management activities in groups to be provided through separate legal entities; if advice and investment management are permitted through the same licensed entity, disallow the charging of separate fees for these services; if multiple fees are chargeable by different group entities, require explicit customer consent to all layers of fees; and / or disallow any sharing or splitting of fees between a group's advice operations and its investment management operations.

Stakeholder views on most of these proposals were mixed. Some indicated disagreement with all of these proposals collectively, while others indicated agreement with all of them. More nuanced views were as follows:

- *Common branding proposal:* The majority of (but not all) commentators supported this proposal, with some, including one large industry association, expressing strong support. Although all commentators supported clear disclosure (and customer acknowledgment) of the status of the advice provided and of the relationship between the adviser and applicable investment managers or product suppliers within groups, not all were persuaded that co-branding is necessary to achieve this. Some suggested that "co-branding" of advice and investment services would be more appropriate than requiring use of the same common brand. Practical challenges were raised regarding the use of a single common brand in groups with multiple brands. The point was made that disclosure should highlight not only the relationship between group entities but also the impact of such relationships on the status of the advice provided.

- *Requiring separate licences and separate legal entities for advice and investment management services in groups:* Views on this proposal were divided. Those opposed to it argued that it would simply create more complex group structures without addressing any underlying conflicts that may exist. The point was made that the same conflict risks can arise regardless of whether

[13] These amendments have been finalised after consultation and have been submitted to the National Treasury for onward submission to Parliament.

the respective activities are offered by the same entity or separate entities in a group. Those in support felt that it would enable clearer governance accountabilities and simplify regulatory oversight. Clarity was requested on whether the same group would be able to operate both RFA and PSA advice models.

- *Disallowing the charging of both advice fees and investment management fees by the same entity:* Although a few stakeholders agreed with this proposal, the majority were opposed to it on the grounds that it is inconsistent with the general activity-based approach of the RDR framework – namely that where separate activities are indeed performed they can and should be separately remunerated. One commentator felt that this issue would not arise because investment managers do not provide advice at all.

- *Requiring explicit customer consent for all fees charged by all group entities:* This proposal enjoyed almost universal support. One dissenting view was that consent to separate fees should not be required as consent to the overall fee structure is sufficient.

- *Disallowing fee sharing or fee splitting between advice and investment management operations:* Opinions on this proposal were varied, although a number of commentators expressed strong support. Commentators not in support of the proposal argued that broader proposals regarding disclosure, remuneration and conflict prevention were sufficient and specific intervention in internal fee arrangements was not necessary.

4.3.2. The FSCA's updated position

The FSCA remains of the view that branding is a useful tool to highlight intra-group relationships between advisers, investment managers and product suppliers, over and above more substantive disclosure around these relationships and the status of the advice provided. We are however open to the use of co-branding rather than a single common brand, provided the display of the respective brands is sufficiently prominent to highlight the relationships concerned. We also recognise the potential complexity of common or co-branding requirements in groups with multiple brands and are open to how best to accommodate these models without compromising customer understanding of intra-group relationships in these models.

On the question of whether advice and investment management services can be provided through the same or separate legal entities, stakeholders should refer to our proposals in the *RDR Discussion Document on Adviser Categorisation and Related Matters* (the Adviser Categorisation paper), also published in December 2019, as well as the FSCA's updated thinking regarding investment adviser categorisation in Section 3 of this document. (Also see our updated thinking on adviser categorisation set out in section 3.1.2 and 3.2.2 above.)

- As advised in earlier sections, a group of companies may operate both PSA and RFA advice models, but these must be operated through separate legal entities. The same legal entity cannot act as both an RFA and a PSA.
- An investment manager may appoint a tied adviser (PSA) to provide advice on its behalf. This would require the investment manager to be licensed for advice in addition to its investment management licence, and the PSA would then provide advice through that licence.
- However, in light of the discussion in section 3.2.2 above, note that it will be possible for a PSA appointed by another group entity (for e.g. a product supplier in the group) to also recommend the investment management services (i.e. the entering into of a discretionary mandate) with an investment manager in the group. In such a model, the investment manager will not itself require an advice licence, but governance arrangements must be in place in the group to ensure that the investment manager bears an appropriate level of responsibility for such recommendations.
- We also confirm that an investment manager will not be disallowed from holding an advice licence as an RFA, where it wishes to provide both advice and investment management

services. However, investment managers adopting such a model will need to take care to ensure that appropriate controls are in place to ensure that the advice so provided is objective and not biased in favour of the investment managers or its group's own products or services (in other words to ensure that it is indeed acting as an RFA and would not be better positioned as a PSA).

The FSCA agrees with the view that disallowing the same entity from charging both advice and investment management fees, where both such licences are held, is inconsistent with the RDR activity-based approach. We will therefore not proceed with this proposal. However, stakeholders are reminded of our broader proposals regarding enhanced cost disclosure, general remuneration principles including not charging more than once for the same service, and the need for appropriate management of conflicts of interest, as discussed elsewhere in this document and in our other RDR communications.

On the requirement for explicit customer consent to all fees charged by group entities, the majority view in favour of this proposal is in line with the FSCA's broader proposals regarding enhanced disclosure and with recent amendments to the FAIS General Code, discussed elsewhere in this document. It will however be important to ensure that the disclosure framework ensures transparency of the impact of each separate type of cost on investments, as well as the combined effect of all costs.

We will consider further whether any explicit prohibitions of intra-group fee sharing or splitting arrangements in the investment sector are necessary, over and above the various other conflict of interest mitigation measures proposed through our broader RDR proposals.

New question for stakeholder input:

Q28. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding our updated position on mitigating the risk of duplication of charges?

4.4. Facilitating and monitoring advice and other fees

4.4.1. Summary of inputs on the 2018 Investments Document

Views on the proposals for product suppliers, LISP platforms and investment managers to facilitate, monitor and report on advice fees and certain other fees were sharply divided across all aspects of the proposal. Some commentators were full in support of all measures proposed, while others had more nuanced views on different elements of the proposal.

Most commentators had no objection to our proposal requiring fee facilitation, provided that the measures proposed would be practical to implement. Arguments against compulsory fee facilitation were that it should be left up to industry participants to decide whether and to what extent they should facilitate fee deduction and market forces would drive the consequences of such decisions. An argument was made that fee facilitation should be required, but that the type of fee facilitation offered should not be prescribed but left to market forces. A contrary view was that, if fee facilitation is required, it should be limited to the specific options set out in the document. Some stakeholders pointed out that some providers currently set their own maximum fee limits that they are willing to facilitate and argued that this option should remain available.

Views regarding fee monitoring and reporting were even more mixed, with those in favour agreeing that this would provide useful insights for the regulator, although noting that careful data analysis

would be required to ensure correct conclusions are drawn. Some inputs were in favour of fee monitoring, but opposed to reporting of fees, or opposed in particular to reporting of "unusually high" fees. Objections to the latter proposal were mainly that the entity deducting the fee would not have knowledge of the arrangements between the investor and the fee earner and the services provided, and therefore would not be able to make a fair judgment on what is an unusually high fee.

4.4.2. The FSCA's updated position

The FSCA is still considering the divergent views expressed regarding fee facilitation and monitoring and will share our updated thinking in due course. We are also considering whether an information gathering exercise on current fee facilitation practices would assist us in finalising our position.

New question for stakeholder input:

Q29. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding facilitation and monitoring of fees?

4.5. Remuneration for automated advice

4.5.1. Summary of inputs on the 2018 Investments Document

Almost all commentators agreed that no special remuneration standards are required for automated advice and that this service should be subject to all other RDR proposals and other regulatory requirements for the provision of more traditional types of advice. A few commentators did however suggest that where a product supplier in relation to its own products provides automated advice on a "tied" basis, the costs of the automated advice tool will typically already be covered by other product charges and a separate advice fee should not be charged.

The following additional noteworthy points were made:

- As technology evolves, combinations of automated and traditional advice models are likely to emerge. Developments in artificial intelligence will also increase the sophistication of the automated advice tools available. Remuneration models should therefore be flexible enough to accommodate these developments.
- In line with the principle of remuneration being reasonably commensurate with the service provided, remuneration for automated advice should take into account the extent of the service provided, such as the degree of customisation and the robustness of the advice provided.
- Automated advice models are not necessarily cheaper to operate than more traditional models.
- Automated advice models potentially entail the same levels of conflicts of interest as for other advice models. In particular, automated advice tools are often provided in vertically integrated business models, thus presenting the same conflict risks as other vertically integrated scenarios.
- Customers must be informed that automated advice is being provided and any fees for such advice must be disclosed to enable informed decisions around opting to use automated advice, no advice or more traditional advice models.
- Both additional and ongoing advice fees should be permissible for automated advice, provided evidence of ongoing advice can in fact be provided (although there was a minority view that automated advice should only attract a once-off fee).

4.5.2. The FSCA's updated position

The FSCA agrees that no separate remuneration dispensation is required for automated advice and that equivalent standards and principles should apply to all advice models. We also agree with the various additional points summarised above. Regarding the view that an additional fee should not be charged where the costs of automated advice are covered by other product charges in "tied" models, we believe that this is addressed by the general remuneration principle that fees should not be charged more than once for the same service and our other proposals regarding avoiding intra-group conflicts of interest.

New question for stakeholder input:

Q30. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding our updated position on remuneration for automated advice?

4.6. Remuneration for non-advice distribution

4.6.1. Summary of inputs on the 2018 Investments Document

Commentators flagged that an appropriate remuneration model for non-advice distribution models requires broader consideration of the different types of non-advice distribution models in the market, including distribution models beyond the investments sector alone. It was pointed out that different business models and remuneration / charging practices currently apply, for example, for non-advice call centre scripted sales; non-advice services offered by entities that also provide advice; and non-advice on-line sales. Useful inputs were provided on current practices in each of these models.

There was a general view that providers of non-advice execution services should be able to charge a fair and reasonably commensurate fee for their service, although views differed on the extent to which elements of such a fee should be prescribed. (There was however a contrary argument made that no separate "execution" fee should be charged in non-advice models as execution costs should be covered by the investment management fee). In particular, a few commentators questioned the appropriateness of charging a fee linked to the value of the investment for such non-advice services. On the other hand, other commentators pointed out that a fixed fee might not be sustainable for smaller entities.

There was full agreement on the need for clear disclosure of any such fee and its impact on the investment, and customer consent. There was also agreement that it should be clear that no advice fee could be charged in these cases.

4.6.2. The FSCA's updated position

The FSCA will further consider whether any explicit remuneration standards are required for non-advice distribution models, taking the above inputs into account, as part of our development of broader RDR proposals regarding these models (see in particular RDR proposals D, EE and WW).

New question for stakeholder input:

Q31. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding remuneration for non-advice distribution?

4.7. Mitigating the risk of conflicted exercise of discretionary mandates

4.7.1. Summary of inputs on the 2018 Investments Document

There was general recognition that models where an investment manager uses a discretionary mandate to place investments in portfolios managed by the investment manager itself or its associates, do present material conflict of interest risks – particular in business models where investment management fees are charged both by a "model portfolio manager" and an underlying investment manager in the same group[14]. A number of commentators felt that these risks were mitigated by other proposals regarding disclosure, avoidance of intra-group conflicts of interest, general RDR remuneration principles and common law fiduciary obligations of holding a discretionary mandate. A number of commentators highlighted that applying the so-called "double dipping" principles set out in Collective Investment Schemes Act Board Notice 90 to these models, would also assist.

There was also broad agreement that where different fees are charged these should be for demonstrably separate services. This would entail the model portfolio manager (multi-manager) being able to justify a separate value adding service from that of the underlying investment manager (asset manager). This would in turn require clear disclosure of the difference in the services provided by each of these entities.

On the other hand, opposing arguments were made that business models entailing multiple layers of investment managers and other providers in the value chain have led to significant increases in the overall cost of investing and compromised investment returns. One commentator proposed that the total of all fees outside of the investment management fee (i.e. platform fees; multi-manager / model portfolio fees; and advice fees) should be capped a stated percentage of the underlying investment management fee (asset manager fee).

4.7.2. The FSCA's updated position

The FSCA will take the inputs regarding conflicted exercise of discretion into account as we develop more concrete regulatory frameworks for the proposals set out in Sections 2 and 3 of this document. Feedback on this document will also inform our thinking.

New question for stakeholder input: *Q32. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding mitigating the risk of conflicted exercise of discretionary mandates?*

PART C. Stakeholder input and next steps

Investments sector stakeholders are invited to provide input on the FSCA's updated thinking as set

[14] Using the investment management categorisation proposed in Section 2 of this document, this would refer to both multi-management and asset management activities bring performed by different investment managers in the same group.

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out in this document, using the Feedback Template attached as *Annexure A.* Feedback received will inform further informal consultation or the development of draft formal regulatory instruments – which will in turn be subject to our ordinary prescribed consultation processes.

Please submit feedback to FSCA.rdrfeedback@fsco.co.za by **no later than 31 March 2020**.

ANNEXURE A

FEEDBACK TEMPLATE

RETAIL DISTRIBUTION REVIEW (RDR):

SECOND DISCUSSION DOCUMENT ON INVESTMENT RELATED MATTERS

DATE	Complete
NAME OF ORGANISATION	Complete
TYPE OF ORGANISATION	Complete
CONTACT DETAILS	Complete

Question for stakeholder input:
Q1. Please provide your views on the proposed elements to be covered by a definition of "discretionary investment managements". Any suggestions for a draft definition are welcome.

Issue/ Comment/ Recommendation

Question for stakeholder input: *Q2 Do you have any suggestions on how best to mitigate the risk of regulatory arbitrage between advice and discretionary investment management? In particular, do you agree that the practice of "copy trading" presents such a risk and do you have any suggestions as to an appropriate regulatory treatment of this practice?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q3. Please provide your views on the proposal to split the activity of discretionary investment management into three sub-activities of asset management, multi-management and alternative investment management.*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q4. Do you have any suggestions for appropriate definitions of each of these sub-activities?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q5. Please provide your views on appropriate fit and proper requirements for each of the proposed sub-activities (asset management; multi-management; alternative investment management) in relation to:* *(a) Operational requirements* *(b) Minimum qualifications* *(c) Minimum experience* *(d) Class of business training* *(e) Product specific training* *(f) Continuous professional development.*

Please indicate in what respects (if at all) the above requirements should differ for each sub-activity and to what extent they should differ from the existing competency requirements for FAIS Category II or IIA FSPs.
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q6. Which competency requirements, if any, do you believe should apply equally to all three sub-activities?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q7. Do you believe there is currently scope for arbitrage between the fit and proper requirements for different licence categories in the investments sector and, if so, do you have any suggestions on how this could be resolved?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q8. Do you agree that the dispensation for "mandates for convenience" should be restricted to retail investors? If you believe it should not be so restricted, please provide examples of where such a mandate would be appropriate in the non-retail space.*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q9. Please provide suggestions on an appropriate term to denote a "mandate for convenience".*

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Issue/ Comment/ Recommendation
Question for stakeholder input: *Q10. Please describe the specific types of transactions you believe are appropriate to be authorised under a "mandate for convenience", recognising the need to avoid inappropriate arbitrage between these mandates and discretionary investment management mandates.*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q11. Do you support the proposal for a prescribed standard template with a "menu" of pre-defined permissible transactions for these "mandates for convenience"?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q12. Do you foresee any unintended consequences of the FSCA's view that "mandates for convenience" should not be extended to include switches between similar CIS portfolios?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q13. Do you foresee any unintended consequences of imposing no additional fit and proper competency requirements for holding a "mandate for convenience" over and above the applicable requirements for a FAIS Category I (advice) licence?*

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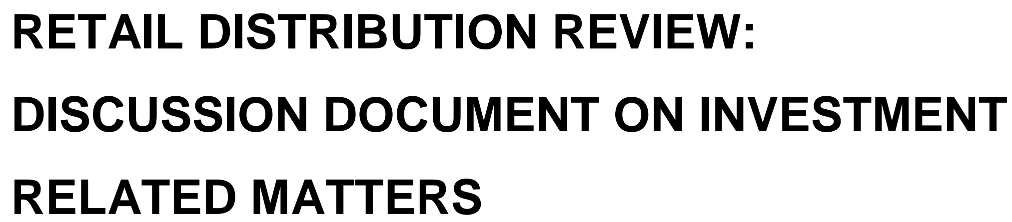
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q14. Please provide suggestions for appropriate governance, record keeping, disclosure and / or regulatory reporting requirements to be imposed on the holder of a "mandate for convenience".*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q15. Do you agree that CIS management companies and LISP platforms should be required to verify that a "mandate for convenience" is in place before acting on the instruction of such a mandate holder? If not, why not?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q16. Please provide your views on the FSCA's proposed approach to allowing investment managers to appoint "tied" advisers.*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q17. Please provide your views on the FSCA's proposed approach to PSA's of CIS management companies.*
Issue/ Comment/ Recommendation

Question for stakeholder input: *Q18. Please provide your views on the FSCA's proposed approach to the use of LISPs by tied advisers where there is no LISP platform in the group*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q19. Please let us know whether you prefer option (1) or (2) above in respect of the use of LISPs by tied advisers where there is a LISP platform in the group. Please explain why you prefer this option.*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q20. Please describe any business models you are aware of where a LISP platform's role goes beyond purely administrative functions and could potentially influence investment management decisions or investment advice.*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q21. Please describe any business models you are aware of where it would be necessary or appropriate for a LISP platform to be able to appoint its own tied advisers.*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q22. Please provide your views on the FSCA's proposed approach to when advice in relation to 3rd party co-branded portfolios may be described as*

"independent".
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q23. Please provide your views on the nature, prevalence and potential conduct risks of so-called "co-named broker funds" that are not operated as formal 3rd party co-branded CIS portfolios.*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q24. Do you agree that a LISP platform should be required to ensure that no branded portfolio is allowed on its platform unless it has verified that the entity concerned is licensed as an investment manager and does in fact hold and act on discretionary mandates in relation to the branded solution? If not, why not?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q25. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding appropriate levels of due diligence between different entities in the investments value chain?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q26. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding our updated position on cost*

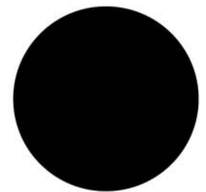
disclosure?
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q27. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding our updated position on mitigating the risk of duplication of charges?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q28. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding our updated position on mitigating the risk of duplication of charges?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q29. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding facilitation and monitoring of fees?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q30. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding our updated position on remuneration for automated advice?*

Issue/ Comment/ Recommendation
Question for stakeholder input: *Q31. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding remuneration for non-advice distribution?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q32. Pending further consultation, do you have any specific views you wish to share with the FSCA at this stage regarding mitigating the risk of conflicted exercise of discretionary mandates?*
Issue/ Comment/ Recommendation
Question for stakeholder input: *Q33. Please provide any further general comments you may have on the Discussion Document.*
Issue/ Comment/ Recommendation



RETAIL DISTRIBUTION REVIEW:
DISCUSSION DOCUMENT ON INVESTMENT RELATED MATTERS

June 2018



FSCA

Financial Sector
Conduct Authority

SECTION 1. Background and context

The Financial Services Board's Retail Distribution Review published in November 2014 ('the initial RDR proposals") put forward a number of proposals to reform the regulatory framework for distribution of financial products, aimed at ensuring distribution models that:

- Support the delivery of suitable products and fair access to suitable advice for financial customers
- Enable customers to understand and compare the nature, value and cost of advice and other services intermediaries provide
- Enhance standards of professionalism in financial advice and intermediary services to build consumer confidence and trust
- Enable customers and distributors to benefit from fair competition for quality advice and intermediary services, at a price more closely aligned with the nature and quality of the service
- Support sustainable business models for financial advice that enable adviser businesses to viably deliver fair customer outcomes over the long term.

A key focus of the RDR is to remove or mitigate certain inherent risks of conflict of interest between intermediaries and financial product or service providers on the one hand, and their customers on the other – notably the risk of conflicted advice.

Against that background, the initial RDR proposals included specific proposals aimed at clarifying the nature of the legal and business relationships between financial product and service providers. These included proposals aimed at a clearer categorisation of different types of financial advisers, and proposals aimed at reducing the risk of conflicted advice in certain outsourcing arrangements between product suppliers (for this purpose, including investment managers) and advisers. Since the publication of the initial RDR proposals, the FSB and the FSCA have published a series of status updates on the phased implementation of the RDR proposals.

This Discussion Document focuses on the impact of certain of the initial RDR proposals on the investments sector. The purpose of this Discussion Document is to:

- **Share our observations and current thinking** on specific initial RDR proposals insofar as they impact on the investments industry - in particular Proposal Z (relating to outsourcing activities to advisers) and Proposal K (relating to adviser categorisation) – in the light of stakeholder inputs received; and

- **Elicit stakeholder input** on possible regulatory measures to -
    - Define the activity of "investment management" and consider the extent to which investment management needs to be demarcated from other forms of discretionary investment mandate;
    - Clarify the nature of the legal and business relationships between different types of discretionary investment mandate holders, collective investment scheme management companies and investment advisers, and how best to structure these in the regulatory framework to achieve our RDR objectives; and
    - Provide for fee and remuneration arrangements in light of the above, to align with the RDR approach of aligning remuneration with actual activities performed and avoiding unnecessary duplication of costs for the end investor.

SECTION 2. Updated thinking based on input received

2.1. Initial proposals and earlier updates

The suggested regulatory measures put forward in this Discussion Paper have been prompted mainly by the wide-ranging and useful inputs we received to the following initial RDR proposal[1] (in particular the second paragraph of the proposal) and subsequent updates:

> *Proposal Z: Restricted outsourcing to financial advisers*
>
> *As a general standard, the outsourcing of product supplier functions or investment management functions or activities (as opposed to true intermediation activities connecting product suppliers and customers, as discussed in paragraph 4.1.2) to financial advisers will be prohibited, other than in the case of specific identified and regulated functions.*
>
> *Note that this proposal includes a prohibition on a CIS manager outsourcing investment management to an "authorised agent" (as defined in the Collective Investment Schemes Control Act) or to any intermediary through a third-party arrangement where that authorised agent or intermediary is also a financial adviser.*

In its December 2016 RDR Status Update, the FSB provided an update regarding Proposal Z in the investments space, highlighting the need to consider the appropriate categorisation of investment advisers within the RDR framework – notably in what circumstances an investment adviser could be regarded as a "product supplier" agent (PSA)[2] of an investment manager.

In the December 2016 update the FSB also flagged a number of concerns and intentions in relation to the complex structure of the current investment landscape, and the need to clarify these in licensing and regulatory frameworks. These included: A concern that the current FAIS regulatory framework does not clearly demarcate the respective roles and customer value propositions in cases where the same entity provides both advice and discretionary investment management services to the same customers; and our intention to therefore define and develop standards for the specific activity of "investment management". The FSB also expressed concern that the initial RDR proposals did not adequately address the potential conflict of interest risks that may apply to holders of discretionary investment mandates.

2.2. Observations based on inputs received

The initial proposal and updates summarised in section 2.1 elicited extensive feedback from a wide range of entities in the investment sector, including traditional investment managers, CIS management companies (both those offering third party co-branded structures - sometimes called "white label" structures - and those who do not); third party co-branded providers themselves; administrative FSPs (linked investment service provider or LISP platform operators); providers of so-called "model portfolios" or "wrap funds"; and a wide range of investment advisers more generally. Commentators ranged from substantial financial conglomerates to small "niche" discretionary mandate holders and individual advisers (both with and without Cat II licences).

Having considered all these inputs, our updated observations are as follows:

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[1] Proposal Z should be read with *Proposal J: Outsourced services on behalf of product suppliers to be more clearly defined and regulated.*

[2] Please see section 3.2 of this document for further detail on the RDR adviser categorisation approach.

(a) Our concerns regarding the complexity of current investment product distribution models, and consequent risks of conflicts of interest and customer confusion, are confirmed. This is particularly so in vertically integrated business models, where multiple components of the investment product value chain are provided within the same group of companies.

(b) We remain of the opinion that third party co-branding arrangements (commonly referred to as "white label" arrangements), whereby CIS management companies outsource investment management to intermediaries who are also financial advisers, pose conflict of interest risks. However we no longer propose to prohibit all such arrangements, but to seek alternative ways to mitigate these risks.

(c) We recognise that our focus on mitigating risks of conflicted investment advice should not focus only on third party co-branded models, but also consider the role of other types of discretionary mandate holders, such as so-called "model portfolio" or "wrap fund" providers.

(d) The nature and scope, and hence the likely value for money, of discretionary investment services provided by Category II FSPs varies significantly. We recognise that a number of advisers who also hold discretionary mandates are skilled investment professionals who provide value-adding services to their customers. Unfortunately however, the current very broad FAIS definition of a "discretionary FSP"[3] does not provide an effective mechanism for ensuring that such FSPs do indeed always perform a meaningful and value-adding service.

(e) Another consequence of the broad definition of a discretionary FSP is that it does not support the RDR activity-based approach, which requires that remuneration should be commensurate with the nature, extent and quality of actual services provided and should be paid by the user of such services. So for example charges currently described as "investment management fees" are sometimes deducted for services that are in fact more akin to investment administration services on the one hand, or for services that are in fact little more than investment advice on the other.

(f) The legal construct of the relationship between advisers and other entities is not always an accurate reflection of the actual nature of their business relationships. More particularly:

- In third party co-branding arrangements, the legal and regulatory construct is that the CIS management company outsources its investment management function (inherent in its CIS manager licence[4]) to the third party concerned. As such, the third party is in law managing the CIS portfolio/s[5] concerned in the name of[6] and on behalf of the CIS management company as its agent. It also follows (as confirmed by the relevant CIS Regulations) that the CIS management company retains full legal accountability for the investment

[3] A "discretionary FSP" is currently defined (in summary) as an FSP "that renders intermediary services of a discretionary nature as regards the choice of a particular financial product … but without implementing any bulking".

[4] This is why CIS management companies are not required to hold a separate FAIS Category II licence. The customer does not sign a discretionary mandate. Instead, investment discretion is exercised in accordance with the founding mandate (investment policy) of the CIS portfolio itself and is exercised either directly by the CIS management company or to a Category II FSP to whom the management company outsources the function. In third party co-branding arrangements these Category II FSP's are typically entities outside the CIS management company's own group, whereas in non-third party models the CIS management company typically (although not always) outsources investment management to a Category II FSP in its own group.

[5] These could include "fund of fund" portfolios.

[6] This is legally the case, notwithstanding that the portfolio is also co-branded by the third party.

performance of the portfolios concerned and for ensuring compliance with all regulatory requirements in relation to the management and administration of the investments by the third party. In reality however, the third party does not regard itself as – and does not behave as – the agent of the CIS management company in relation to the carrying out of its discretionary investment mandate. Instead, it regards the portfolio/s concerned as its own "product" which it offers to its own customers. Similarly, the investors do not typically see themselves as the customers of the CIS management company, but rather as the customers of the third party. Notwithstanding the legal construct, it is *de facto* an arrangement where the third party acts as the discretionary investment manager for its own customers, but "insources" the administrative (not discretionary investment management) capabilities[7] of the CIS management company to support it in doing so.

- In the case of model portfolio / wrap fund structures[8], on the other hand, there is typically no outsourcing arrangement in place between the CIS management company that provides the CIS portfolio/s being invested in and the Category II FSP. The customer signs a discretionary mandate with the Category II FSP. In many cases, the model portfolio / wrap fund is offered through an administrative FSP (LISP) platform. The customer (or the Category II FSP on the customer's behalf) therefore also signs a mandate with the LISP. Additional contractual arrangements are in place between the Category II FSP and the LISP, as well as between the LISP and the CIS management company concerned. Although the legal construct therefore differs from that of the third party co-branding model, the de facto business relationship between the Category II FSP and the customer is similar – the Category II provider regards the model portfolio / wrap fund concerned as its own "product", and the customer sees themselves primarily as the customer of the Category II FSP, not the customer of the LISP (despite also signing a mandate with the LISP) nor the customer of the management company.

Accordingly, the approach we have adopted to outsourcing standards under our RDR framework for other financial sectors, such as the recently strengthened binder regulations in the insurance sector, may not be effective or appropriate in the investment space, or at least not for all business models in the investment space. Instead, we need to identify regulatory interventions that are better suited to the realities of investment distribution models.

(g) Industry participants use inconsistent and sometimes inaccurate terms to describe their customer offerings and relationships with one another. For example:
- The terms investment manager; asset manager; fund manager; discretionary investment manager (or DIM); and discretionary fund manager (DFM), are sometimes used interchangeably but sometimes used to mean different things
- The terms wrap fund; model portfolio; broker fund; house view portfolio, are also sometimes used interchangeably but sometimes used to mean different things
- Some advisers talk about "outsourcing" discretionary services to DIMs / DFMs, whereas there is in fact no outsourcing arrangement between the adviser and the DIM / DFM at all, but at best a referral and / or fee sharing type of arrangement.

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[7] These administrative capabilities relate primarily to unitisation and pricing of the participatory interests in the portfolio, compliance and reporting functions, and administration of taxation processes.

[8] Note that these do not include "fund of fund" models, which are approved CIS portfolios in their own right.

Question for stakeholder input:
Q1. Do you agree with our above observations regarding the investment landscape? If not, where do you disagree? Are there any additional considerations you believe we have overlooked that are necessary to inform our regulatory proposals?

SECTION 3. Matters for consultation

3.1. Defining and understanding different activities performed under a discretionary investment mandate

In the course of our RDR consultations, we have identified four broad categories of Category II FSP activities:

(a) So-called **"traditional" investment management**, typically entailing portfolio construction through analysing and selecting the underlying instruments (i.e. shares, derivatives, bonds, cash and property – whether local or foreign) making up one or more portfolios. This group typically provides one or both of the following investment management services:

i. Discretionary investment management for CIS management companies on an outsourced basis on behalf of the management company, usually without interacting directly with particular CIS investors. The CIS management company appoints the investment manager to manage the assets in one or more of its CIS portfolios in accordance with the founding mandate (investment policy) of the portfolio concerned; and

ii. Discretionary investment management of a portfolio of assets held for a specific investor (usually a pension fund, corporate or high net worth individual) on a segregated basis in accordance with a discretionary mandate agreed with the investor concerned.

(b) **Third party co-branded investment management (sometimes referred to as "white label" arrangements):** This activity is similar to the discretionary investment management carried out by traditional investment managers acting on behalf of CIS management companies (as described in paragraph (a) (i) above) and also entails the investment manager acting on behalf of the CIS management company in relation to managing one or more of the management company's portfolios. In this model however, the portfolios are co-branded with the brand of both the CIS manager and the third party investment manager, and are marketed and distributed by the third party investment manager (usually through its own Category I financial advisers, advisers in its group or third party distribution channels) to investors. In some cases, the third party investment manager itself is also a Category I financial adviser. These arrangements are often entered into with CIS management companies that wholly or partially specialise in third party co-branded structures. In many such models, the third party investment manager "owns" the distribution channel concerned, although the CIS management companies have varying degrees of involvement in supporting the distribution channel. Models also exist where the third party investment manager (with its related distribution channel) has a direct ownership interest in the CIS management company.

(c) **"Model portfolio" management:** This entails selecting and designing customised or "model" portfolio solutions for groups of customers or individual customers, in most cases comprising a selection of participatory interests in existing CIS portfolios. The model portfolio may however also include non-CIS investments, such as individual securities or other instruments. Where the model portfolio solution comprises CIS portfolios offered by a number of different providers, the model portfolio provider is usually referred to as a "multi-manager". Similarly to third party co-branding investment managers, these providers also market and distribute their model portfolios to investors through their own Category I licence; through Category I financial advisers in their group; or through unrelated distribution channels.

(d) **Mandates held mainly for convenience:** These entities perform no or very little actual portfolio construction, design or selection, but obtain a discretionary mandate from customers primarily for the sake of convenience, to obviate the need to obtain new written instructions from the customers whenever portfolio switches between existing structures are made – typically for purposes of rebalancing the composition of the portfolio to align with the customer's previously

selected asset allocation.

Note that in many cases the same entity performs more than one of activities (a) to (d) above.

Question for stakeholder input:
Q2. Please let us know whether you agree or disagree with our categorisation of investment management activities into the four broad groupings set out above and our description of each type of activity? If you disagree, where do you disagree and how would you group or describe the activities differently? Suggestions on the appropriate terminology to describe each category of activity will also be welcome.

Despite the very different range and scope of the four broad business propositions outlined above, in the current FAIS framework all such entities hold the same licence – a Category II discretionary FSP licence – and would all be able to charge investment management fees for their services. We therefore believe that it is necessary for the licensing framework – and associated qualifying criteria and conduct standards - to distinguish more clearly between these types of activities.

Question for stakeholder input:
Q3. Do you agree in principle that the current criteria for a FAIS Category II licence are overly broad and that it is necessary for the regulatory framework to distinguish more clearly between different types of discretionary investment mandate activities? If you disagree, please explain why.

Regulatory measures we are considering include:

Measure 1: Define the typical activities and combinations of activities, over and above merely holding a discretionary mandate from a customer, which can accurately be described as "investment management". Possible activities include:
- Asset selection ("stock picking") from a universe of underlying instruments, including shares, derivatives, bonds, cash and property, whether local or foreign;
- Structuring combinations of such selected assets into portfolios ("portfolio construction") designed to achieve different investment objectives, whether by class of asset, industry sector, type of investment strategy or style, or combinations of these – which may or may not entail structuring portfolios to meet different investment risk profiles;
- Research and analysis of assets and their issuers / providers, to inform the above asset selection and portfolio construction activities; and
- Performing the above activities on an ongoing basis to ensure that the portfolios concerned perform in accordance with agreed mandates – being either the investment policy of a particular CIS portfolio, or a segregated mandate from a particular customer.

Measure 2: Test the different types of discretionary activities summarised in paragraphs (a) to (d) above, against the definition of "investment management" to determine which activities can most accurately be described as investment management activities so defined.

The FSCA's initial views are as follows:
- So-called traditional investment managers are likely to meet the definition
- Third party co-branding investment managers are likely to meet the definition
- Model portfolio providers may or may not meet the definition, depending on their particular service offerings, and consideration should be given to whether they should be separately categorised
- Mandates held mainly for convenience are unlikely to meet the definition. The value proposition of such mandates going forward should be considered, including whether they should be separately defined or categorised.

Measure 3: Set appropriate fit and proper standards – including both operational and competence requirements - **to qualify for the new definition of "investment management".** Discussion will be required as to whether these requirements should be more rigorous than the current FAIS Category II and, where applicable, Category IIA licence and conduct requirements. The competency requirements would include appropriate "line of business" training focused on the activities that are defined as core to the activities comprising investment management.

Measure 4: Create a different licence category for entities that perform activities currently classified as Category II, but which will not meet the new "investment management" definition. A possible designation is **"model portfolio provider" (MPP)**. This will also entail identifying and defining the activities or combinations of activities concerned. Possible activities include:

- Selecting and combining existing investment portfolios (being CIS portfolios or portfolios constructed by one or more "investment managers" as redefined) to form customised portfolio solutions designed to achieve the investment objectives of individual customers or groups of customers ("model portfolio construction"). Such combinations of portfolios may be structured by class of asset, industry sector, type of investment strategy, or combinations of these and will often entail structuring portfolios to meet different investment risk profiles;
- Research and analysis of existing investment portfolios and the investment managers who construct them, including due diligence on the investment managers, to inform the above model portfolio construction decisions;
- The model portfolio provider may or may not enter into an arrangement with a Category III FSP (LISP) to offer its model portfolio/s on the LISP's platform;
- Performing the above activities, as well as ongoing monitoring of the performance of the underlying investment portfolios against their underlying mandates, on an ongoing basis to ensure that the model portfolios concerned perform in accordance with agreed customer mandates – being the discretionary mandate between the customer concerned and the model portfolio provider.

Note that the above activity description assumes that a "model portfolio" only comprises combinations of existing underlying pooled portfolios, rather than non-pooled assets such as directly held securities or instruments. This raises the question as to how, under the approach discussed above, the provider of a portfolio comprising both existing pooled investments and non-pooled investments should be categorised? Would their activities fall outside the more limited scope of an MPP and require them to be licensed as an investment manager (because they will be performing actual asset selection / "stock picking") rather than an MPP?

Note that it would be permissible for the same entity to act as both an investment manager (as per the proposed new definition) and an MPP. If different licence standards are to be set for investment managers and MPPs, an entity that meets the licensing standards for an investment manager would in all likelihood also meet the standards required to be licensed as an MPP, so separate licences would not be required. The licence holder would however be required to ensure that any individuals operating on its licence meet the standards applicable to the specific activity they perform.

Measure 5: Set appropriate fit and proper standards – including both operational and competence requirements - **to qualify for the new definition of "model portfolio provider".** Discussion is required as to whether these should be somewhat less rigorous than the requirements to be proposed for "investment management". The competency requirements would include appropriate "line of business" training focused on the activities that are defined as core to model portfolio provision. Requirements could also include an obligation for MPPs to provide prescribed minimum disclosure documents in respect of their model portfolios, similar to the "MDDs" required in respect of CIS portfolios.

Question for stakeholder input:
Q4. Please provide your views on the correctness, feasibility and likely effectiveness of each of the possible approaches to discretionary investment mandate categorisation (Measures 1 to 5) set out above. Please let us know if you have any alternative categorisation suggestions.

In particular, please provide your views on –

(i) whether or not different, more rigorous fit and proper standards (including competency financial soundness and operational ability requirements)should apply to investment managers (to be defined) as compared to model portfolio providers (MPPs) and why you hold this view;
(ii) if you agree that different standards should be set for investment managers and MPPs, which standards should apply to providers of a portfolio comprising both existing pooled investments and directly held non-pooled assets?;
(iii) if you agree that different standards should be set for investment managers and MPPs, please provide suggestions on what the key differences between these standards should be; and
(iv) regardless whether you believe that investment managers and MPPs should be subject to different fit and proper standards, whether the current FAIS fit and proper standards for Category II FSP's are adequate and appropriate for investment managers, MPPs, or both or whether you believe any amendments would be required in light of the measures proposed in this paper.

Measure 6: Consider whether entities that hold discretionary mandates primarily for convenience purposes, without performing either "investment management" or "model portfolio provider (MPP)" activities as discussed above, should continue to be regarded as performing a discretionary activity. Arguably, by more clearly defining the activities required for investment management and / or model portfolio management, the so-called "convenience" mandate holder would no longer meet the applicable licence criteria. These types of mandate holders would therefore either naturally fall away, or could continue to exist but be defined and categorised as an activity separate from investment management / portfolio management. If these types of mandates are to continue, then consideration could be given to disallowing the charging of any type of investment management fee or other remuneration for such services. Given that these entities would typically also be investment advisers, the argument would be that the discretionary mandate in these cases is purely ancillary to the investment advice services, intended primarily to ensure that the portfolio composition remains in line with the advice previously provided, and should therefore not be eligible for a fee over and above the advice fee agreed to by the customer.

Our current thinking is that there is a case to be made for retaining these types of mandates, provided that:

- These intermediaries are not regarded as exercising investment discretion but rather as holding a more limited authority to perform specified services under a written "standing authorisation" from a customer, without having to obtain the customer's separate written instruction on each such occasion;
- The transactions to be executed under such an authorisation would be limited to those required to rebalance the client's portfolio - at certain pre-agreed periods of time back to the percentage fund exposures and / or asset allocation (in the existing selected portfolios / underlying assets) that the client originally agreed to, or to place additional investments into the same portfolios that the client originally agreed to;
- The intermediary is not regarded and may not describe itself as an investment manager or a model portfolio provider, as the case may be (unless they also in fact hold such licences);
- The intermediary may not receive a fee for this service over and above an advice fee negotiated with and agreed to by the customer; and
- The intermediary will be required to meet the same fit and proper standards as required for advice in relation to the types of investment products concerned.

Question for stakeholder input:
Q5. Do you agree that so-called "mandates for convenience" should continue to be permissible? If not, why not? If yes, please provide your views on the proposed provisos set out under Measure 6. Do you agree that this activity is ancillary to advice provided in relation to the investments concerned?

3.2. Categorising investment advisers within an RDR framework

The observations discussed in Section 2 of this discussion document make it clear that there is a need to understand the actual contractual and business relationships between the various links in the investment product value chain, and ensure that the regulatory framework is consistent with these. This raises the particular question of how financial advisers providing advice on investment products should be categorised within our future RDR adviser categorisation model, to best reflect the nature and status of the advice they provide and their relationship with other components of the financial product value chain.

In summary, the proposed RDR adviser categorisation model distinguishes between:

- Product supplier agents (PSAs), who operate on the licence of a product supplier and may provide advice on the products of that product supplier (and other product suppliers in its group) only; and
- Registered financial advisers (RFAs), who will be separately licensed in their own right to provide advice on whatever products their licence permits, and are not limited to offering the products of any particular product supplier/s.

Importantly, the same entity will not be permitted to operate as both a PSA and an RFA. A clear choice between the two categories of adviser will be required.

In previous RDR publications, we raised the question whether, and if so in what circumstances, an investment adviser should be regarded as a product supplier agent (PSA) in the above model. More particularly, we said we will consult on whether, in certain cases, an investment adviser should be regarded as the PSA of an investment manager (currently a Category II FSP). In subsequent stakeholder engagements, the further question has arisen whether, in certain cases, an investment adviser should be regarded as the PSA of a CIS management company, or even of a LISP (Category III FSP).

Note that classification as a PSA means that the product supplier concerned is itself licensed to provide advice, with the adviser doing so on its behalf as its agent, and that the product supplier is fully accountable for the quality of the advice and all associated compliance obligations.

In the current FAIS regulatory framework, a Cat II FSP is regarded as a form of intermediary, not a product supplier. Related to this, investment portfolios are not currently regarded as "products" for FAIS purposes[9]. Instead, the FAIS product definitions refer only to the underlying assets within a portfolio – and, in the CIS case, the participatory interests in the CIS portfolio. The RDR categorisation as a PSA, on the other hand, entails acting as agent of a "product supplier" and advising on that supplier's "products". Accordingly, changes to the current regulatory framework and / or the RDR categorisation model would be needed if advisers were to be regarded as PSAs of an investment manager[10].

Similar regulatory framework challenges apply if an adviser were to be regarded as a PSA of a Cat III FSP (a LISP platform provider). Cat III FSPs are also currently regarded as intermediaries, not product suppliers and their platform / bulking activities are regarded as an intermediation service in

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[9] In practice however, many investment managers describe and position their portfolio offerings as their "product", and financial customers think of their investment in such offerings as an investment "product" they have "bought" from the investment manager.

[10] Note however that the future Conduct of Financial Institutions (COFI) Act is expected to define the term "portfolio" as well as to expand the definition of "advice" so as not to be limited to underlying assets only. These changes will potentially support the positioning of an investment portfolio as a financial product for advice purposes.

relation to underlying products and portfolios, not as a "product"[11]. This creates the following anomaly for purposes of our RDR adviser categorisation: Our proposal is that although a PSA is limited to providing advice on the products of product suppliers in its own group, this includes "open architecture" investment offerings offered through a LISP platform administered by a Cat III FSP that is part of the group. In the current framework however, the Cat III is not a "product supplier" and does not offer a "product".

Regarding an adviser as the PSA of a CIS management company does not pose these regulatory framework difficulties. CIS management companies are already product suppliers for regulatory purposes, and participatory interests in CIS portfolios are already defined as financial products. There would therefore be no regulatory obstacle to a CIS management company appointing an adviser as its PSA. However, in practice, there are few if any business models we are aware of where a CIS management company appoints its own agents to provide advice on its behalf and takes accountability for such advice. Even in third party co-branded models, the third party investment manager is legally the agent of the CIS management company in relation to the investment management activities it performs (through an investment management outsourcing arrangement), but where that third party investment manager also provides advice, it does not usually do so as agent of the CIS management company.

An additional consideration is that CIS management companies are currently exempt from FAIS in relation to any advice activities that the management company performs. The rationale for this exemption was that CIS legislation provides sufficient investor protection to mitigate the risks of the management company itself providing advice in the course of its ordinary CIS management and administration activities[12]. This exemption would however create an anomaly that would need to be addressed if a CIS management company were indeed to adopt a business model of appointing its own PSAs to provide advice on its behalf.

Measure 7: Provide for the possibility of an adviser being categorised as the PSA of an investment manager (to be defined as discussed above) or a LISP by –

either -

(a) Refining the RDR adviser categorisation model, by providing that a PSA may operate either as the agent of a financial product supplier or a financial service provider[13]. This would obviate the need to regard investment managers as "product suppliers" or to regard the investment portfolios they offer as financial "products". In the case of a LISP, this approach would similarly obviate the need to regard a LISP as a "product supplier". Instead, both investment managers and LISPs could continue to be regarded as service providers, but would be able to appoint PSAs. Accordingly, this approach would be more consistent with the current regulatory framework. In financial groups, this would mean that a PSA could provide advice on any financial product or financial service offered by any licensed entity – including investment managers and LISPs - in the group. Note however that this approach would require an extension of the current definition of "advice" beyond purely recommendations relating to identified financial products, but also include recommendations of identified financial services;

or -

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[11] Some commentators have argued that, in practice, a LISP plays a similar role in relation to administering investments to that of a CIS management company (which is indeed a product supplier), except that it uses the method of "bulking".

[12] The current definition of "administration" in the Collective Investment Schemes Control Act includes advice.

[13] Definitions of financial product provider and financial service provider would be linked to those used in the Financial Sector Regulation Act.

(b) Expanding the definition of "financial product" to include the investment portfolios offered by investment managers[14]. The effect of this would be that investment managers would be regarded as product suppliers for regulatory purposes, and could appoint PSAs as their agents to provide advice on their products (i.e. their portfolios). This approach would obviate the need to extend the scope of a PSA beyond advice on "products". Note however that this approach does not comfortably lend itself to the possibility of an adviser being able to operate as the PSA of a LISP – it is difficult (although arguably not impossible) to position a LISP's services as a "product" and a LISP as a "product supplier".

Regardless of whether (a) or (b) above is adopted, all other implications of being a PSA would apply in either approach, namely: The investment manager or LISP concerned (or another entity in the group) would need to be licensed to provide advice, with the individual advisers concerned acting as their agents (individual PSAs). The investment manager or LISP concerned would be fully responsible for the advice provided by its PSAs in relation to its services / products. The PSAs would also only be permitted to offer the services / products (i.e. the investment portfolios – or co-branded investment portfolios where applicable) of that investment manager only; or the platform services of that LISP only; or the products or services of other entities in the same group only.

Question for stakeholder input:
Q6. Which of option (a) or (b) under Measure 7 above do you believe would be most appropriate to provide for the possibility of an investment adviser acting as the PSA of an investment manager or LISP? If you do not believe that either option is appropriate or necessary, please explain why and let us know if you have any alternative suggestions. In particular, please indicate whether or not you believe it is necessary to provide for the situation where an investment adviser could act as the PSA of a LISP and why you hold this view.

Measure 8: Consider how to apply Measure 7 to model portfolio providers (MPPs) as contemplated in section 3.1(c) above. This assumes that MPPs would hold a separate type of licence from investment managers (including third party co-branding investment managers). If so, either option (a) or (b) under Measure 7 could equally be used to allow an investment adviser to operate as the PSA of an MPP in a similar way to where an investment adviser could act as the PSA of an investment manager. In other words, using option (a) an MPP would be regarded as providing a financial service (model portfolio provision) and the PSA would provide advice on such services; or using option (b) the model portfolios of the MPP would be regarded as "products" and the MPP as a "product provider". Under either approach, an investment adviser appointed as a PSA of the MPP would provide advice only on the model portfolios of that MPP or on other products or services provided by other entities in the MPP's group.

Question for stakeholder input:
Q7. Would your answer to Question 5 above in relation to allowing an investment manager to appoint a PSA be the same in relation to allowing an MPP to appoint a PSA as discussed under Measure 8? If not, why not?

Measure 9: In light of Measures 7 and 8 above, **confirm that an investment manager (either a traditional investment manager or a third party co-branding investment manager) and / or an MPP may utilise multiple distribution channels for the distribution of its portfolios / model portfolios to investing customers if it so wishes.** These include:

- Establishing its own PSA channel – either by also holding an advice licence itself, or having a

[14] Please also see footnote 10 above.

PSA entity in its group. In this case, the investment manager / MPP is fully accountable for any advice provided by the PSAs. The PSA channel will also only be able to offer the investment manager / MPP's own portfolios, or other products or services provided by other entities within the group (including a LISP platform);

- Having an ownership interest in or association with an RFA channel. In this case, the regulator would monitor the extent to which the RFA channel promotes the investment offerings of the investment manager / PPM itself, as opposed to offerings from outside the group, in order to assess whether the advice provided remains sufficiently objective to warrant ongoing categorisation as an RFA (as opposed to a PSA). Note that in such a model the RFA channel would not be able to describe its advice as "independent";
- Having no PSA channel and no relationship with an RFA channel, with its portfolios being marketed on a fully arms' length basis by RFAs; or
- Combinations of the above.

Question for stakeholder input:
Q8. Do you agree that all of the distribution model options described in Measure 9 should be available to all investment managers and MPPs and do you agree with the descriptions of each model? If not, why not?

Measure 10: Clarify the nature and implications of the outsourcing relationship between the CIS management company and a third party co-branding investment manager and their respective regulatory responsibilities[15]. Provisions we are considering include the following:

- Setting clear standards on the responsibilities of the CIS management company in relation to the third party investment manager and the co-branded "white labelled" portfolios concerned. These standards will confirm that the CIS management company retains full accountability for all aspects of the third party manager's outsourced investment management activities and the performance of the portfolios concerned. Standards will also include governance and oversight requirements, operational requirements and data sharing requirements[16].
- Confirming that a CIS management company may only enter into a third party co-branding arrangement – or any other outsourced investment management arrangement - with an investment manager that meets the new definition of that activity and is licensed accordingly[17].
- Clarifying that the third party investment manager acts as the agent of the CIS management company specifically in relation to its investment management activities, but not in relation to any advice provided by the third party investment manager or its associates (unless of course they are appointed by the CIS management company as its PSA – see Measure 11 below). Note however that this does not imply that the CIS management company may wash its hands of all responsibility in relation to advice provided by the third party investment manager on the outsourced portfolios concerned. As with any other product supplier, the CIS management company will in terms of our overall RDR proposals be expected to take reasonable steps to mitigate the risks of poor advice provided by intermediaries marketing its products[18]. The fact that the CIS management company has entered into a co-branding arrangement with the third

[15] Note that these requirements would apply equally to so-called "incubator" white label models, as provided for in the existing CIS regulatory framework.

[16] The intention would be to align these requirements, to the extent appropriate, with corresponding outsourcing requirements imposed on insurers in relation to binder holders and other outsourced administration providers.

[17] Note that, in addition to the accountability borne by the CIS management company that outsources its investment management activity to the third party investment manager, the third party is itself also accountable for its own conduct in accordance with its licence as an investment manager.

[18] See initial RDR Proposals BB to EE in relation to product supplier responsibility.

party investment manager will mean that the CIS management company will be expected to play a more proactive role in such risk mitigation than it would in relation to investment advisers marketing its portfolios on a fully arms' length basis[19].

- Note too that any advice provided by a third party co-branding investment manager – even where it operates as an RFA - would not be able to be described as "independent", as a result of its outsourcing relationship with a product supplier (the CIS management company).[20]
- Confirming that the CIS management company's accountability for the investment management activities of the third party co-branding investment manager also extends to the use of any LISP platform in relation to the co-branded portfolios concerned. In other words, the CIS management company's responsibilities in relation to the use of a LISP for co-branded portfolios would be the same as in relation to any other situation where a CIS management company offers its own (not co-branded) portfolios through a LISP.

Question for stakeholder input:
Q9. Please provide your views on the correctness, feasibility and likely effectiveness of each of the possible provisions set out under Measure 10 to regulate CIS white label arrangements. Please let us know if you have any alternative suggestions.

Measure 11: Confirm that a CIS management company may, if it so wishes, appoint a PSA to provide investment advice as its agent. This could include appointing a third party co-branding investment manager (that also has a Category I licence to provide advice) with whom the CIS management company has an outsourcing arrangement, as its PSA in relation to the co-branded portfolios concerned[21]. As with any other PSA, such an adviser would be limited to marketing the portfolios of the CIS management company only (including the co-branded portfolios), or the products / services of other entities in the CIS management company's group. This approach may require a change or clarification of the scope of the current FAIS exemption of CIS management companies, to confirm that the management company and the PSA would indeed be subject to relevant FAIS obligations relating to the provision of advice if this type of distribution model is selected by the management company. It would also require an amendment to CIS legislation to remove "advice" from being regarded as part of the scope of the CIS management company's administrative activities.

Question for stakeholder input:
Q10. Do you agree that a CIS management company should be able to appoint a PSA to provide advice on its portfolios? If not, why not? If yes, do you agree with the above description of the implications of such an arrangement?

Measure 12: **Clarify the adviser categorisation implications of using a LISP platform outside the adviser's group – in particular in relation to PSAs within the group.** As explained previously, a PSA will be limited to providing advice on the products or services of entities within its own group only. If the regulatory measures suggested in this paper are followed, this would include

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[19] This is consistent with our various RDR communications where we have indicated that the extent of a product supplier's responsibility for advice provided in relation to its products should be commensurate with the risk of such advice being influenced by the product supplier.

[20] This is consistent with our RDR approach where we have indicated that certain relationships – including outsourcing relationships – between financial advisers and product suppliers will disqualify the advice concerned from being described as "independent".

[21] Note however that this would only be permissible where the third party co-branding investment manager concerned does not also provide advice on any other portfolios it may also manage in its own name or though another third party co-branding arrangement with another CIS management company.

investment portfolios and / or model portfolios offered by entities within the group. This would also extend to other portfolios / model portfolios provided by investment managers or MPPs outside of the adviser's group, but only if such external portfolios are offered on a LISP platform operated by a group entity. Concerns have however been raised that this approach places PSAs in groups that do not have their own LISP platform, at a competitive disadvantage to PSAs in groups that do have a LISP platform. In particular, the concern has been raised that, in order to offer investment products requiring an underlying life insurance licence, such as living annuities and underwritten retirement annuities or preservation funds, advisers need access to a LISP that is part of a group that also holds the requisite life insurance licence. Accordingly, a PSA in a group that does not have a LISP and a life licence would – so the argument goes - no longer be able to offer such products.

The following are regulatory options that could be considered in response to this concern:

(a) Maintain a strict "no gap filling" approach to PSAs, disallowing a PSA from offering products / portfolios through a LISP platform outside its group. Advisers wishing to provide advice on products / portfolios through an external LISP platform will therefore have to act as RFAs, not PSAs. As a result, such advisers will also need to be able to demonstrate that their advice is not biased in favour of their own group's other offerings. This approach would be potentially problematic, for example, in the case of an MPP that wants its advisers to offer only its own model portfolio solutions for discretionary investments, but use an external LISP for annuities or retirement products where it does not hold the requisite licence. Referrals to other advisers / investment managers who do have access to such products would however be possible;

(b) Allow the PSA channel to advise on products / portfolios on an external LISP, but only where -
- There is no LISP platform within the home group;
- An investment manager or MPP within the home group has structured the portfolio / model portfolio concerned and accepts full accountability for its performance and for the advice provided by the PSAs on such portfolios; and
- An investment manager or MPP, or other appropriate entity within the home group, has undertaken an adequate due diligence of the LISP concerned (see Measure 14 below); or

(c) Allowing the PSA channel to advise on products / portfolios on an external LISP, but only where the criteria in (b) above apply and the group concerned is below a certain size and scale. The rationale for such an approach would be to recognise that the establishment of an "in-house" LISP has cost implications for smaller businesses, but to encourage those who have the capacity to do so to set up their own LISP platform if they wish to use a PSA model.

Question for stakeholder input:
Q11. Which of options (a) to (c) under Measure 12 above do you believe would be most appropriate to deal with the implications for PSAs of using a LISP platform outside their group? If you do not believe that any of these options is appropriate, please explain why and let us know if you have any alternative suggestions.

Measure13: Clarify the adviser categorisation implications of acting as a third party co-branding investment manager as well as holding another type of discretionary mandate.
Models where a Category II FSP manages co-branded portfolios through a CIS management company that is not part of the same group, but also manages its own segregated and / or model portfolios, are not uncommon. Similarly to the concerns raised under Measure 12 in relation to the use of external LISPs, this raises questions regarding the scope of advice that a PSA channel operating in such a group would be permitted to provide. Our proposed approach to this situation is as follows:
- The fact that the co-branded portfolio is managed on an outsourced basis on behalf of an external CIS management company should not prohibit the PSA channel of the third party co-branding investment manager from providing advice on such portfolios. Such a prohibition

would ignore the practical reality that the third party investment manager itself structures the co-branded portfolio [22]– it is therefore for practical purposes an "in-house" offering of the PSA's group.
- It follows that the PSA channel within a group that manages a combination of co-branded portfolios as well as its own segregated portfolios and / or model portfolios will be able to provide advice on all such offerings – as well as any other products or services of entities within the group.
- If any such portfolios are offered on an external LISP the options discussed in Measure 12 above are applicable.

Question for stakeholder input:
Q12. Do you agree that the details under Measure 13 correctly describe the adviser categorisation implications of acting as a third party co-branding investment manager as well as holding another type of discretionary mandate? If not, why not? Are there any additional implications we have not identified that might influence the adviser categorisation in these business models?

Measure 14. Set clear requirements for due diligence reviews to be carried out before various contractual arrangements between parties in the investments value chain are entered into. Arrangements requiring appropriate due diligence reviews include:
- A CIS management company to perform a due diligence review on any investment manager to whom it outsources any investment management function – including but not limited to outsourcing to a third party co-branding investment manager.
- A CIS management company, investment manager or MPP to perform a due diligence review on a LISP before placing any of its portfolios / model portfolios on the LISP's platform.
- A LISP to perform a due diligence review of any CIS management company, investment manager or MPP before accepting its portfolios onto the LISP platform.
- An MPP to perform a due diligence on any underlying investment manager and / or CIS management company whose portfolios it utilises to construct its model portfolios.
- A financial adviser (other than a PSA) to conduct a due diligence on any investment manager, MPP or CIS management whose investment offerings it selects to recommend to its customers, including being able to demonstrate the selection process it uses.
- A general requirement for any CIS management company, investment manager or MPP to satisfy itself that any distribution channel it selects to distribute its investment offerings is suitable.

Note that any due diligence referred to above extends beyond simply confirming that the entity concerned holds the requisite licences. It should take into account the "fit" with the business model and investment offerings concerned, with due regard to the delivery of fair outcomes for the target investor base concerned.

Question for stakeholder input:
Q13. Do you agree that an appropriate due diligence review should be required in all of the scenarios set out under Measure 14? Are there additional arrangements requiring due diligence that we have not mentioned? Do you have any suggestions as to what such due diligence requirements should comprise?

[22] Bear in mind that our proposed activity-based definition of "investment manager" would ensure that this is the case.

3.3. Implications for remuneration and charging structures

In our initial RDR proposals, the following principles for intermediary remuneration were identified as necessary to support the desired RDR outcomes[23].

> *Intermediary remuneration:*
>
> *Greater clarity on the activities that make up advice, intermediation and outsourced services respectively, as well as on whose behalf the services are rendered, creates the foundation for a clearer set of principles and rules for intermediary remuneration.*
> *To achieve the desired RDR outcomes, it is proposed that the future regulatory framework for intermediary remuneration should meet the following criteria:*
> - *Intermediary remuneration should not contribute to conflicts of interest that may undermine suitable product advice and fair outcomes for customers.*
> - *As part of this aim, intermediary remuneration should not undermine reasonable customer benefit expectations or inhibit customers' access to their savings (such as through early termination charges designed to recover commission costs).*
> - *The regulatory framework should recognise the range of services available, the related remuneration for these, and who may pay or receive it.*
> - *All remuneration must be reasonable and commensurate with the actual services rendered.*
> - *Remuneration structures should strike a balance between supporting ongoing service and adequately compensating intermediaries for up-front advice and intermediary services.*
> - *Ongoing fees and / or commission may only be paid if ongoing advice and services are indeed rendered.*
> - *An intermediary may not be remunerated for the same or a similar service twice.*
> - *All fees paid by customers must be motivated, disclosed and explicitly agreed to by the customer.*
> - *The different types of services and fees should be readily comparable by customers; and*
> - *Remuneration structures should promote a level playing field between different types of intermediaries providing similar services.*

The initial RDR proposals also make the following very important point in relation to remuneration and charging structures in the investments space: *The potential consumer impact of unfair or inappropriate charging structures is particularly important in the investment product space, where product, distribution and advice related costs all have a direct impact on the ability of products to meet reasonable customer benefit expectations.*[24]

Existing RDR remuneration related proposals applicable to the investments sector

Against this background, the following remuneration related measures specifically applicable to the investments sector are already included in our initial RDR proposals. We intend to proceed with setting standards in respect of each of these proposals, subject to applicable refinements arising from previous and future consultation processes:

- *Proposal HH:* General disclosure standards in relation to fees or other remuneration

[23] See pp. 47 to 48 of the initial RDR proposals. Also note that a number of these principles are included in proposed revisions to the FAIS General Code of Conduct.

[24] See p.51 of the initial RDR proposals.

- *Proposal JJ:* Standards for up-front and ongoing product advice fees
- *Proposal KK:* Additional standards for ongoing advice fees
- *Proposal LL:* Product suppliers to facilitate advice fees
- *Proposal MM:* Remuneration for selling and servicing investment products
- *Proposal SS:* Standards for remuneration arrangements between adviser firms and their individual advisers
- *Proposal TT:* Special remuneration dispensation for the low income market
- *Proposal YY:* Remuneration for investment platform administration.

Possible additional regulatory measures in relation to remuneration and charging structures in the investment sector:

In addition to the above-mentioned earlier RDR proposals, we also need to consider additional implications for the remuneration and charging structures of investment related products and services, arising from the various regulatory measures proposed in this paper.

We are considering the following additional regulatory measures:

Measure 15. Engage with ASISA and other stakeholders on how best to use and / or enhance the ASISA Effective Annual Cost (EAC) disclosure mechanism to ensure effective customer understanding of the quantum and impact of all "layers" of charges in the investment value chain[25]. This would include all investment manager and MPP charges, any other administrative charges, LISP platform charges and advice fees.

> ***Question for stakeholder input:***
> *Q14. Do you support the use of ASISA's EAC cost disclosure mechanism as proposed and do you have any suggestions as to how it could be applied or adapted to support the desired RDR outcomes regarding cost transparency in the investments sector?*

Measure 16. Consider how best to mitigate the risk of inappropriate duplication of fees and charges by different entities in the investment value chain. Questions to consider include:

- In third party co-branded models, how do we ensure that the fees charged by the CIS management company and the third party investment manager respectively are appropriately allocated between them and are reasonably commensurate with the respective activities they perform? How do we ensure that the total cost is reasonably consistent with the fees charged by the CIS management company on any other portfolio in a similar asset category?
- In MPP models, how do we ensure that the fees charged by the MPP for its model portfolio management and those charged by the relevant CIS management company and / or traditional investment manager respectively are appropriately allocated between them and are reasonably commensurate with the respective activities they perform?

> ***Question for stakeholder input:***
> *Q15. Please provide your views on the questions raised under Measure 16 in relation to mitigating the risks of duplication of charges. Are there any other risks of inappropriate duplication of fees and charges in the investments sector that we should be considering?*

Measure 17. Consider how best to mitigate the risk of conflicted advice in cases where an

[25] Note that EAC based disclosures do not however replace any other cost disclosures required by regulation or international standards.

investment manager or an MPP, or an adviser forming part of the same group as the investment manager or MPP, provides advice to customers in relation to their own (or own group's) portfolios / model portfolios, but are not structured as a PSA – in other words, where they purport to provide "non-tied", objective advice in relation to their own / own group's offerings?

Possible regulatory responses – or combinations of responses - include:

- In such business models, set clear standards requiring the adviser and the portfolios / model portfolios concerned to carry the same branding and for the relationship between the adviser and the investment manager / model portfolio provider to be prominent in all marketing and advertising material;
- Disallow an investment manager or MPP from holding a licence for advice in its own right – i.e. require that any advice provided in relation to the portfolios / model portfolios concerned must be provided by a separate legal entity (which may or may not be part of the same group);
- If an investment manager or MPP is permitted to provide advice through the same licence, disallow the charging of both advice fees and investment / portfolio management fees in relation to the portfolio/s concerned – i.e. require that only one fee be chargeable in such models covering both the investment management / portfolio management and advice activities;
- If both advice fees and investment / portfolio management fees are chargeable, oblige the adviser to obtain the customer's explicit consent to not only the advice fee but also any other fee chargeable by any other entity in the group; and/or
- Disallow any sharing or splitting of advice fees and investment manager / MPP fees between the advice operations and the investment manager / MPP operation – i.e. ensure that there is an explicit distinction between these sets of fees and the services to which they relate.

Related questions are: Should the above approaches differ between traditional investment managers, third party co-branding investment managers, and MPPs respectively? Do the risks of conflicted advice in these respective models differ and if so how?

Question for stakeholder input:
Q16. Please provide your views on each of the possible regulatory responses noted under Measure 17 in relation to mitigating the risks of conflicted advice. Are there any other risks of conflicted advice in the investment sector that we should be considering?

Measure 18: Clarify the responsibilities of various entities in the investment value chain in relation to facilitation and monitoring of advice fees and other charges. Provisions we are considering include:

- Confirming that all of the following entities will be required to facilitate the deduction and payment of advice fees to an adviser, when instructed to do so by the customer concerned: Insurers, CIS management companies, LISP platform providers and, where applicable, investment managers themselves. The rationale for obliging these entities to facilitate fee deductions would be to mitigate the risk that an adviser's recommendation of an investment offering will be influenced by the ease of being able to access advice fees, rather than by the suitability of the investment for its customer.
- Prescribing the minimum advice fee structures that these entities will be required to facilitate. Current thinking is that these should include providing customers with the option of requesting once-off, monthly or annual advice fee facilitation through any of the following mechanisms:
    - A once-off fee added to a lump sum contribution and then paid across to the adviser;
    - Ongoing fees added to regular investment contributions and then paid across to the adviser at the same frequency as the regular contribution. (We do not propose that this needs to be through a separate debit order); and
    - Ongoing deductions from investment values, expressed as a percentage of the

investment value of the portfolio concerned[26].

- Requiring these entities to monitor average advice fee levels on an aggregated basis and report these to the regulator. This is likely to include specific reporting of cases where the fee level is unusually high as compared to the norm for the type of service concerned, in the experience of the reporting entity. The purpose of such reporting would be to support the FSCA in monitoring advice fee trends and in detecting "outlier" fee charging practices, in order to mitigate conduct risks. We will consult further on the structure and detail of such reports and provide guidance if necessary.
- Possibly extending the facilitation and / or monitoring and reporting obligations beyond advice fees to also apply to MPP fees (depending on whether these are chargeable separately from advice fees).

Question for stakeholder input:
Q17. Please provide your views on the correctness, feasibility and likely effectiveness of each of the possible provisions set out under Measure 18 in relation to facilitation and monitoring of fees and charges. In particular, do you agree that the provisions should extend beyond advice fees, and if so in what circumstances? Please let us know if you have any alternative suggestions.

Measure 19: Consider the appropriate remuneration mechanism for "automated advice". Recent amendments to the Determination of Fit and Proper Requirements under the FAIS Act define automated advice (sometimes referred to as "robo advice"), clarifying that it is regarded as a form of advice under the current FAIS framework. In principle, such "robo advice" should therefore be able to attract an advice fee. This raises the question how to ensure that any such fee is reasonably commensurate with the automated service provided.

Question for stakeholder input:
Q18. Please provide your views on the appropriate remuneration model for automated advice services.

Measure 20: Consider the appropriate remuneration model for distribution of investment products through non-advice models. RDR proposal MM stipulates that no remuneration may be paid to any intermediary for selling or servicing investment products, other than advice fees agreed to by the customer (subject to a special dispensation to be developed for the low income market under proposal TT). However, as noted in our initial RDR proposals, because proposal MM deals with advice fees, it follows that as currently positioned it only applies to intermediated distribution models that do in fact entail the provision of advice. This begs the question whether there is a need for a different remuneration / charging model for distribution of investment products on an "execution only", non-advice basis.

Question for stakeholder input:
Q19. Please provide your views on the appropriate remuneration model for non-advised investment product sales. Inputs on the current extent and structure of such models will be appreciated.

Measure 21. In addition to our concerns regarding the risk of conflicted advice in relation to investment products, we are also concerned that **the exercise of a discretionary mandate – even where no advice is provided – can result in a conflict of interest** where the mandate is used by the investment manager or MPP concerned to select portfolios / model portfolios offered by the

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[26] We will consider whether this facility requires amendment to any applicable legislation limiting the deduction of amounts from the value of investment, savings and retirement products.

mandate holder itself or its associates. The conflict of interest risk arises particularly where fees are payable for the management of a segregated / customised client portfolio (or model portfolio) as a whole, in addition to investment management fees on the underlying investments. We are therefore considering how best to mitigate the risk of conflicts of interest in these cases.

Question for stakeholder input:
Q20. Please provide your views on how best to mitigate the risk of conflicted exercise of discretion in the situation discussed under Measure 21. Inputs on the current extent of such models – i.e. where investment management fees are charged by both the model portfolio provider and the underlying investment manager/s - will be appreciated.

SECTION 4. Next steps

Stakeholder input on the specific questions raised in this Discussion Document will inform the development of draft subordinate legislation in relation to our various RDR proposals impacting the investments sector. Such draft subordinate legislation will in turn be preceded by additional consultation, as prescribed for the type of regulatory instrument concerned.

Please provide your input by using the attached Feedback Template. Responses should be submitted to FSCA.rdrfeedback@fsca.co.za by no later than 17 August 2018.