PROD, YOUR FIRM AND YOUR CLIENTS

HOW TO PROD-PROOF YOUR BUSINESS

A WHITE PAPER FROM

FIRST THINGS FIRST

This paper was commissioned by Schroders and Cazenove Capital and its purpose is to give advisers a steer in meeting their PROD requirements, specifically understanding the needs of their clients and then matching potential investment solutions to those needs.

PROD – the Product Intervention and Product Governance Sourcebook, to give it the full title – has decent brand awareness in the market and there is a growing (if grudging) acceptance that it's here to stay. However, we're all too aware from our regular discussions with advisers and providers that there are still a good many question marks over both the detail and the regulator's expectations.

Schroders and Cazenove Capital naturally have a commercial interest here, hence their sponsorship of this paper. But they also have an interest in making unbiased and accessible support material easily available to advisers. And that's where the lang cat comes in. To be clear, this is not a paper about identifying or comparing specific offerings. In fact, you won't find any references to investment or platform propositions.

We've written this paper with advisers in mind, but we hope that providers will also find it informative in shedding light on the adviser process and how that shapes the lens through which they are looking at their products.

CONTENTS

INTRODUCTION

Has it really been over 18 months since the introduction of the Product Intervention and Product Governance Sourcebook or, as we know it, PROD? They grow up so quickly these days.

Most firms have by now got over the initial shock, battled through the sleepless nights and are making their way through the difficult teething stage. The good news is that our regular discussions with advisers tell us that most firms are aware of the rules and what needs to be done.

When it comes to what exactly constitutes good practice, however, a number are less clear. What does PROD *actually* require you to do? Is it *just* about segmentation? Is this another regulatory box ticking exercise or is there actually some benefit to it all?

We'll answer all these points and more in this paper.

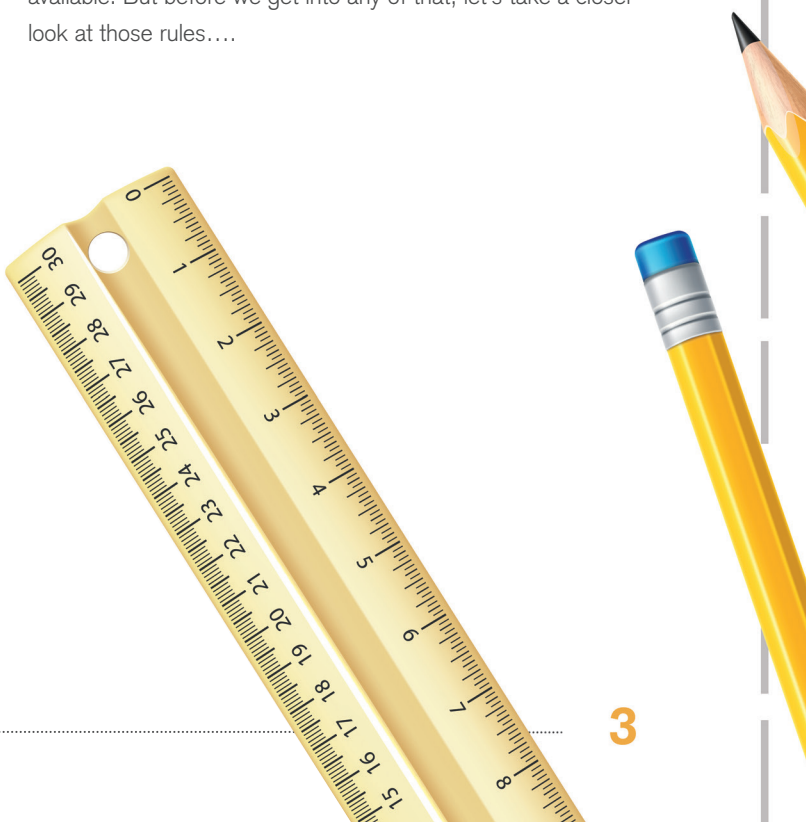
Adviser firms starting from scratch may be heartened to learn that, in most cases, achieving compliance is not *too* much of a stretch. Yes, there is work to be done. But the vast majority of the PROD rules are simply good business sense.

FIRST UP, THE BASICS

The PROD rules were introduced at the start of 2018 as part of MiFID II (the second Markets in Financial Instruments Directive). Their purpose is to create a harder line – with clearer accountability – between product providers and the outcome that the end client receives. In the advised market this means that advisers sit neatly between these two parties and, as such, play a pivotal role.

Advisers have always paid close attention to product design and the services on offer from product providers. In particular, the requirements for robust product research and due diligence are a key element of ensuring client suitability. PROD introduced (some) clarity as to exactly how providers and advisers need to work together for the benefit of their mutual clients, with several shared rules as well as rules specific to each of advisers and providers. Both parties were even given new titles for the occasion – 'distributors' and 'manufacturers' respectively.

This guide offers practical help to advisers – sorry, distributors – with meeting your PROD requirements. Specifically, we'll look at just how you should match the needs of your clients to the vast array of potential investment solutions that are available. But before we get into any of that, let's take a closer look at those rules….



PERFECTING PROD

The key to mastering anything from riding a bike to potentially tricky regulation is to know what you're doing. You can't play the game if you don't fully understand the rules. Well, technically you can, but it won't go well.

While PROD is not the most extensive set of rules ever produced, it's big and detailed enough. With that in mind we've trawled Chapter PROD 3 of the FCA Handbook (Product Governance: MiFID[1]) and selected what we think are the key rules that both distributors (advisers) and manufacturers (providers) need to be clear on and then follow.

One final point – these are all rules, as opposed to guidance. Abiding by them is *not* an option.

MANUFACTURERS

3.2.1

A manufacturer must: (1) ensure that the financial instruments it manufactures are designed to meet the needs of an identified target market of end clients within the relevant category of clients (see COBS 3 for client categories); (2) ensure that the strategy for distribution of the financial instruments is compatible with the identified target market; and (3) take reasonable steps to ensure that the financial instrument is distributed to the identified target market.

3.2.8

Manufacturers must identify the potential target market for each financial instrument at a sufficiently granular level and must: (1) specify the type or types of client for whose needs, characteristics and objectives the financial instrument is compatible; and (2) identify any group or groups of client for whose needs, characteristics and objectives the financial instrument is not compatible.

3.2.16

A manufacturer must make available to any distributor of that financial instrument: (1) all appropriate information on the financial instrument; (2) all appropriate information on the product approval process; (3) the identified target market of the financial instrument, including information about the target market assessment undertaken; (4) information about the appropriate channels for distribution of the financial instrument; and must ensure that the information is of an adequate standard to enable distributors to understand and recommend or sell the financial instrument properly.

1. https://www.handbook.fca.org.uk/handbook/PROD/3.pdf

DISTRIBUTORS

3.3.1

A distributor must: (1) understand the financial instruments it distributes to clients; (2) assess the compatibility of the financial instruments with the needs of the clients to whom it distributes investment services, taking into account the manufacturer's identified target market of end clients; and (3) ensure that financial instruments are distributed only when this is in the best interests of the client.

3.3.3

Distributors must obtain from MiFID manufacturers information to gain the necessary understanding and knowledge of the financial instruments they intend to distribute in order to ensure that the financial instruments will be distributed in accordance with the needs, characteristics and objectives of the target market.

3.3.10

Distributors must identify the target market and their distribution strategy using: (1) the information obtained from manufacturers; and (2) information they have on their own clients.

3.3.18

Distributors must have in place procedures and measures to ensure that when deciding the range of financial instruments and investment services to be distributed, and the target market, all applicable rules are complied with, including but not limited to: (1) disclosure (see COBS 4 and COBS 14.3A); (2) suitability (see COBS 9A); (3) appropriateness (see COBS 10A); (4) inducements (see COBS 2.3A); and (5) conflicts of interest (see SYSC 10.1).

3.2.30

To support the reviews carried out by manufacturers under PROD 3.2.19R to PROD 3.2.26R, a distributor must provide to the manufacturer of each financial instrument it distributes: (1) information on sales; and (2) where appropriate, information on the reviews carried out under PROD 3.3.26R to PROD 3.3.28R.

ALL

3.1.2

A firm must, when manufacturing financial instruments or deciding on the range of financial instruments and investment services it intends to distribute to clients, comply, in a way that is appropriate and proportionate, with the requirements set out in Chapter PROD 3 of the FCA Handbook. In complying with these requirements, a firm must take into account: (a) the nature of the financial instrument or investment service; and (b) the target market for the financial instrument.

In addition to all this, both manufacturers and distributors must follow rules for oversight and training, product approval, compliance reports and post-sale reviews. See 3.3.20, 3.3.15, 3.3.24 and 3.3.26 respectively for the distributor rules.

TO SEGMENT OR NOT TO SEGMENT: THAT IS THE QUESTION

There is a common misunderstanding that PROD requires advisers to segment their client bank. Technically speaking, this isn't quite true. As you'll have seen in our summary of the rules, there isn't anything that specifically mandates segmentation.

However, for most adviser firms a segmented client bank and service offering will be the outcome of following the rules. In particular, the requirement for distributors to *"identify the target market and their distribution strategy using: (1) the information obtained from manufacturers; and (2) information they have on their own clients*[2]*"* will, in all likelihood, identify different groups of clients with similar needs.

Unless your clients all want and need the same thing, and you only have one service offering to meet those needs, the act of meeting the PROD rules will create client segments. A moot point perhaps, but an important one. If you are going to segment your client bank you need to do it in a way that meets the PROD requirements. If not, you risk non-compliance.

WE ASKED ADVISERS, "HOW DO YOU SEGMENT YOUR CLIENTS?"

Phase they may be in their lives. Many factors, however, segmentation also completed back when RDR came in.

We are a relatively new firm and haven't had to segment our service as yet. We are just embarking on this exercise and will likely apply goals based segmentation (accumulation/decumulation/transactional).

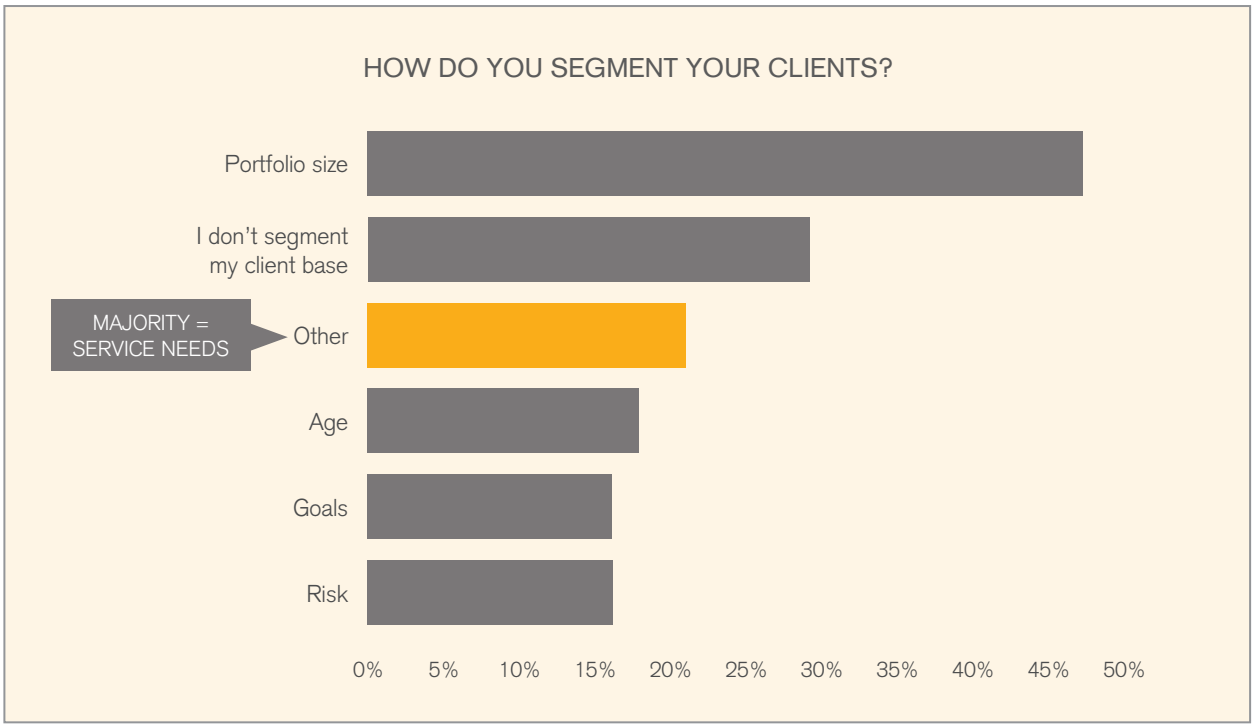
Whether we would classify them as an experienced investor – may change in future.

We have a target market with multiple features. Broadest title is Baby Boomer generation.

2. PROD 3.3.10

SEGMENTATION IS A THING

Our *State of the Adviser Nation* research[3] found that, irrespective of whether PROD was the driving force, a decent proportion of firms have segmented their client bank.



We segment for reporting and research purposes, using the most appropriate KPIs within our database.

Corporate, complex needs/ requirements.

Around 30% of respondents had no form of segmentation. While this is not necessarily an issue for PROD compliance, it does create challenges and is perhaps not best practice.

Those advisers who do segment employ various approaches. The most popular basis for segmentation is portfolio size, with clients typically receiving different services and solutions depending on the amount invested.

We question whether this is the best approach to ensure compliance with PROD, for the firm itself, and, most importantly, for the end client. Segmenting on portfolio size creates risks, specifically of disregarding the cost of delivering the advice service or the end client's needs. Does a client with £95k to invest receive a different service to one with £100k? What happens if the £95k grows to £100k? Or the £100k falls to £95k? Do you deliver a different level of service as a result?

Extreme examples perhaps, but from a business perspective it's much better to focus on the needs of your clients and to then consider how you want to and can meet these needs. This is exactly what PROD requires of advisers.

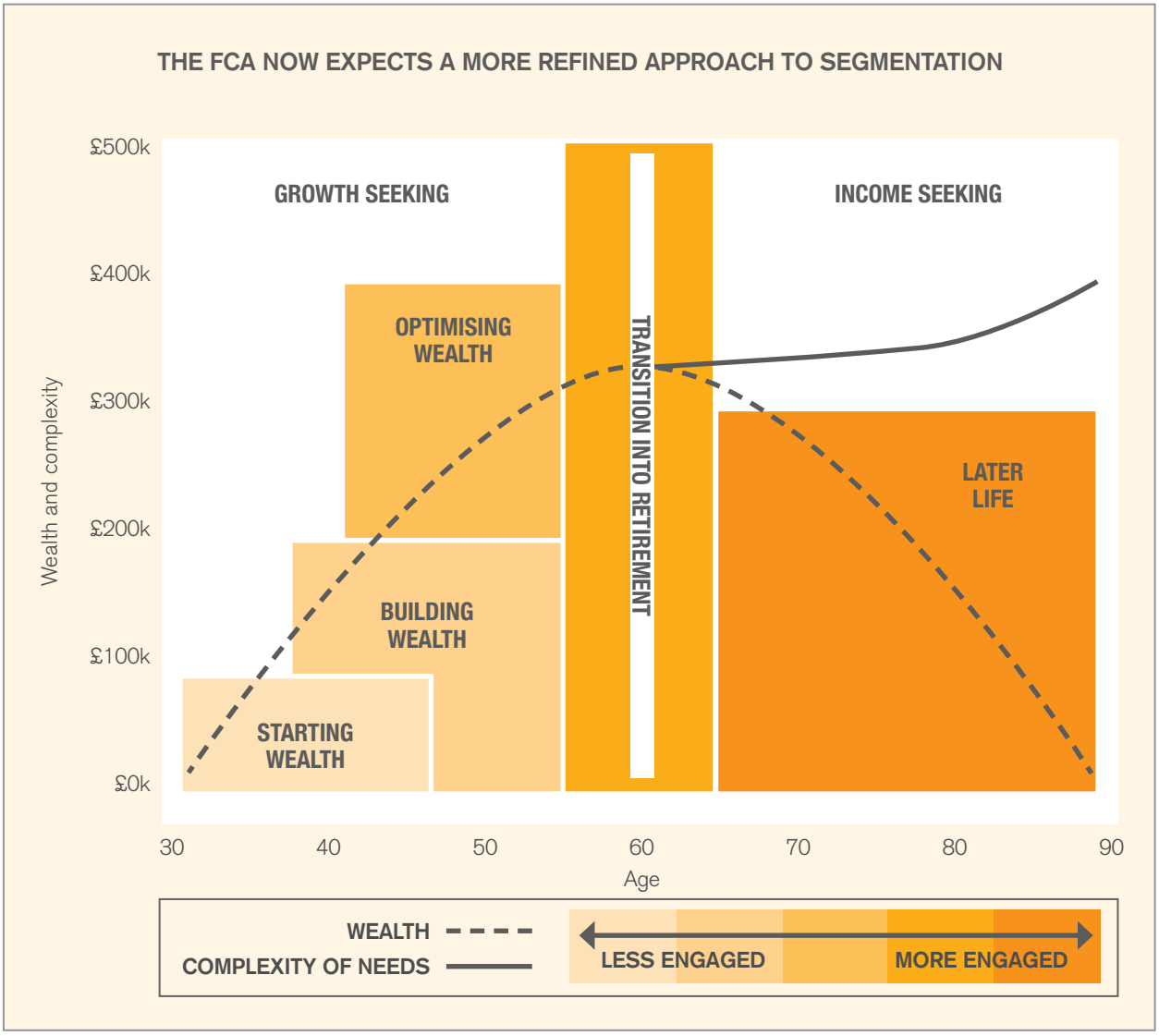
3. We surveyed 235 advisers across October and November 2018.

SEGMENTING BY CLIENT NEEDS

PROD 3.3.10 states that *"Distributors must identify the target market and their distribution strategy using: (1) the information obtained from manufacturers;* and (2) information they have on their own clients". By focusing on client needs, as opposed to their portfolio size, we believe firms can not only ensure compliance with this rule, but also develop a framework whereby different service models can be applied to meet these needs.

THIS IS HOW IT WORKS

Our financial lifestages model is designed to show how individuals will typically have different financial needs as they age.



Articulating those financial needs gives us a better insight into their concerns and priorities.

STARTING WEALTH

"I am just starting to save outside my workplace pension. I need some basic financial education (what do "people like me" need?) and simple, good value access to decent investment returns. I am really focused on getting onto the property ladder."

BUILDING WEALTH

"I have money to invest beyond my workplace pension and mortgage and I am now thinking seriously about planning for my retirement. I need a financial plan and a professional investment portfolio tailored to my individual needs. I need to protect my income and provide for my family if I am critically ill or die."

OPTIMISING WEALTH

"I have saved more than enough for my retirement and I now want to think about more sophisticated investment options, managing my assets in a tax efficient manner and handing over wealth to the next generation."

LATER LIFE

"I am stopping full-time employment and I need to think about the right way to live off my investments. I want financial advice and the right combination of investment, income and protection for my particular needs."

As an advice firm you'll know better than anyone what your clients want or need when they seek your services, and this is the first step to successful PROD compliance. Document these needs and, if you have different groups of clients with different needs, hey presto – you've just created a segment.

SEGMENTING THE SEGMENTS

You might find that within certain segments it's appropriate to create sub-segments where clients share the same overall need but with individual circumstances that call for a different solution. For example, you might decide that you want an "accumulation" segment, where the overall need is for people to save and invest appropriately in preparation for retirement.

However, within this segment you might have both employed clients – with a steady job/income – and business owners, who may not only have a much less consistent income flow, but also perhaps a greater need for tax as well as investment advice. PROD contains guidance (i.e. not a rule but highlighted as good practice) to this effect, saying that

"The target market identified by distributors for each financial instrument should be identified at a sufficiently granular level[4]".

So, once you've decided on your high-level segments it's worth considering whether they contain enough detail, or if some additional sub-segments are required.

There is no set right or wrong way to approach this, but remember the main rule that distributors (advisers) must follow: you must identify your target market and distribution strategy using information you have on your own clients[5]. By focusing on client needs you can meet the first part of this rule, meaning you can then start to consider your distribution strategy.

4. PROD 3.3.12
5. Paraphrased from PROD 3.3.10.

CREATING SERVICES TO MEET YOUR CLIENT NEEDS

Let's assume that as part of the previous exercise you have identified the following example client needs:

SEGMENT	SUB-SEGMENT	CLIENT NEED
Accumulators	Employed	Simple, low-cost investing.
	Self-employed	Low-cost investing and tax planning and regular reviews.
At-retirement	None	Cashflow modelling, holistic retirement planning and regular reviews.

The next step is to consider the services and solutions that will best meet these needs. We suggest that you look at three areas when conducting this assessment.

1. INVESTMENT SOLUTION
Will a single multi-asset fund do the job, or is an in-house model portfolio required? Certain clients might call for a more hands-on discretionary approach. Documenting these requirements will inform your selection criteria. Keep in mind that this process doesn't have to be about looking at specific funds, but about identifying the most appropriate *type* of solution to meet the client's needs.

2. PLATFORM SERVICE
Next, consider whether this client needs a platform, or if an off-platform solution could do just as well. If they do need a platform, is a low-cost option appropriate, or should it be a full "wrap" style offering? Again, document the requirements to inform your selection criteria and then the full research process.

3. ADVICE SERVICE
The final part of this assessment is to consider the advice services that not only meet these needs, but that you want to offer. Individual client suitability is always the most important requirement but, beyond that, no-one is saying what sort of service the client has to receive.

As an adviser this is where you have some discretion to create service models that suit both you and your clients. For example, if there is a need for ongoing client reviews, you could have two service models: annual and remotely (at a lower cost), or twice a year and face-to-face (for a higher fee). Both models meet the need, allowing the client to choose which service they would prefer and are willing to pay for.

We think this template is a good place to start when it comes to meeting the requirements of our favourite PROD rule, 3.1.10.

SEGMENT	SUB-SEGMENT	CLIENT NEED	SERVICE NEED	PLATFORM NEED	INVESTMENT NEED
Accumulators	Employed	Simple, low-cost investing.	Light touch review, and advice available if/when circumstances change.	Off platform if lowest cost.	Intelligently managed, low cost. Multi-asset fund?
	Self-employed	Low-cost investing and tax planning and regular reviews.	Ongoing review as client circumstances dictate.	Platform flexibility to facilitate tax planning via multiple wrappers.	Model portfolios, with ability to trade individual holdings for tax purposes.
At-retirement	None	Cashflow modelling, holistic retirement planning and regular reviews.	Regular review to ensure cashflow plan is on track.	Platform with strong at-retirement functionality.	Range of instruments (cash, funds etc) to enable holistic planning.

There is, however, a lot more to PROD and client suitability than a simple template. PROD recognises this in its requirement for firms to put in place procedures to ensure that once the target market assessment has been completed, all applicable rules are then complied with.

As a consequence, the target market assessment needs to become part of your wider research, due diligence and client suitability framework.

	3.3.18
Distributors must have in place procedures and measures to ensure that when deciding the range of financial instruments and investment services to be distributed, and the target market, all applicable rules are complied with, including but not limited to:	(1) disclosure (see COBS 4 and COBS 14.3A);
	(2) suitability (see COBS 9A);
	(3) appropriateness (see COBS 10A);
	(4) inducements (see COBS 2.3A); and
	(5) conflicts of interest (see SYSC 10.1).

MEETING YOUR FIRM'S PROD REQUIREMENTS: THE LANG CAT FRAMEWORK

The target client analysis mandated by PROD plays a critical role in ensuring client suitability. It's by no means the only element, but it makes an excellent starting point.

As we worked through our template for identifying target clients and their needs in the previous section, we repeatedly mentioned the need to document each stage and its outcomes. The resulting needs and potential platform and investment solutions can then be assessed as part of your normal platform due diligence and investment research processes.

PROD provides some additional guidance on this point, suggesting you should consider:

3.3.11

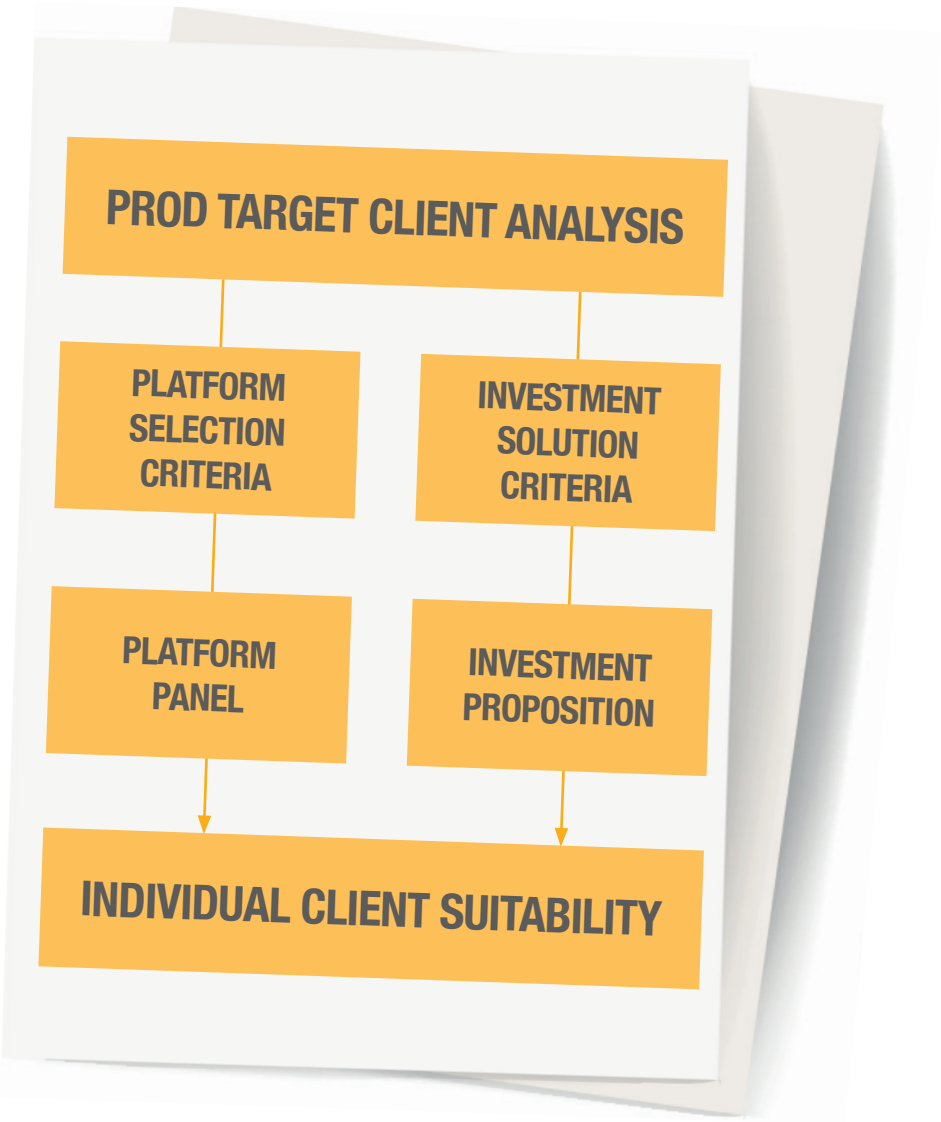
(1) the nature of the financial instruments to be offered or recommended and how they fit with end clients' needs and risk appetite;

(2) the impact of charges on end clients;

(3) the financial strength of the manufacturer; and

(4) where information is available on the manufacturer's processes, how efficiently and reliably the manufacturer will deal with the end client at the point of sale or subsequently, such as when complaints arise, claims are made or the financial instrument reaches maturity.

Combining this assessment with your established platform due diligence process should leave you with three distinct policy documents, all driving towards individual client suitability: your target client analysis, your platform panel, and your investment proposition.



As we mentioned earlier on, PROD requires some additional controls around these policy documents, to ensure that all staff are trained and competent and the outcomes are monitored and reviewed.

CONCLUSIONS

You might recall our bold assertion early on in this paper that for most advice firms, the PROD rules are not too much of a stretch and also happen to make good business sense. Hopefully we've convinced you of these points while also giving you a steer as to what good practice might look like in reality.

It's always dangerous (not to mention a bit foolish) trying to predict the future shape of regulation. One thing we can reasonably assume, however, is that the bar for suitability is only ever going to get higher. Training and adviser competence are major contributors to ensuring suitability, while the rigour and discipline of having documented processes for your advice, platform and investment propositions play an increasingly important role. Not only can this help ensure suitability, but the systems and controls they introduce are of equal benefit to the whole advice business as well.

WHERE TO FROM HERE?

First steps can be tricky, so we've created a checklist to highlight the key points we think advisers need to address when looking to understand their clients and then meet their needs.

These key points can be broken down into three (hopefully) manageable chunks:

SERVICES		
1.	What services do your clients typically want and need? Document these needs, based on your knowledge of your typical clients.	✔
2.	Are sub-segments needed?	✔
3.	What services do you want to offer your clients? How are you going to structure your business to meet these needs?	✔

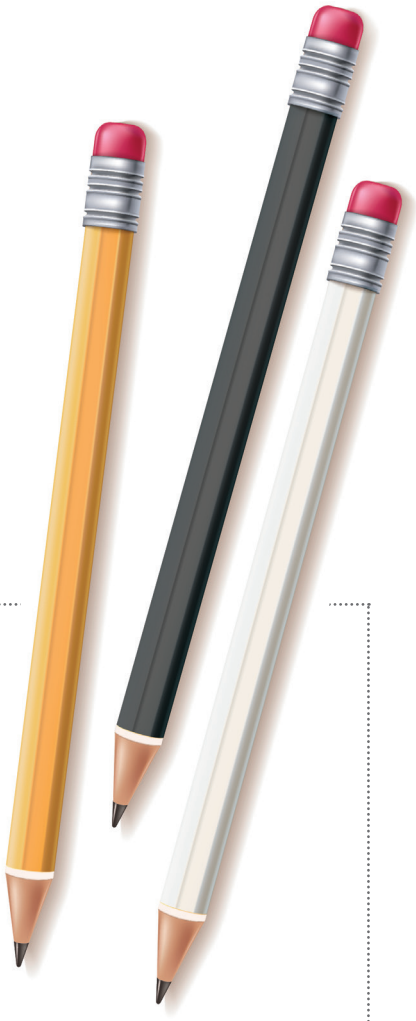
SOLUTIONS		
4.	What products and services best meet these identified needs? What will give the client the best outcome?	✔
5.	Is on- or off-platform investment more appropriate? If a platform is required, what level of functionality is needed to deliver the required outcome?	✔
6.	What investment solution is needed? For example, does the client require a discretionary solution, or is a simpler option such as a multi-asset fund more suitable?	✔

GOVERNANCE		
7.	Fully document your target clients (including any sub-segments) and their required services.	✔
8.	Use the output from the platform and investment solution analyses to create separate platform and investment solution policy documents. These will define both your CIP and platform selection criteria.	✔
9.	Review all outputs with all relevant colleagues. It's important to build in truly open discussion within the business, giving everyone involved the chance to have their say (and, importantly, to be heard), play a full part, challenge the results and buy into the process. Pro tip: the latter is much more likely if there is genuine scope for the rest.	✔
10.	Regularly review your target client material (7.) to ensure the intended outcomes are being achieved and that your typical client needs haven't changed. Also, build in regular reviews for your platform and investment solution policy documents (8.) to ensure suitable recommendations are still being made.	✔

Breaking our checklist down into the three categories not only makes things easier to manage but, depending on how the advice firm is structured, you could also assign responsibility for the first two sections (services and solutions) to different people, reducing the demands and dependency on any one individual or team.

Governance impacts all staff, so it's important that everyone is involved here. Services, however, could be dealt with by the business owner/senior advisers with solutions covered off by a research team/paraplanner.

Follow our checklist and you are well on the way to achieving PROD compliance and ensuring your advice and service propositions are truly meeting the needs of your clients.



FURTHER READING

If you really want to immerse yourself in more PROD and suitability details…

European Securities and Markets Authority (ESMA) Guidelines on MIFID Product Governance Requirements:

https://www.esma.europa.eu/sites/default/files/library/esma35-43-620_guidelines_on_mifid_ii_product_governance_requirements_0.pdf

https://www.fca.org.uk/firms/assessing-suitability – contains details of FCA requirements for research and due diligence, and suitability.

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