

Standfirst: Andy Butterworth and Paul Palmer urge charities to check whether they have been categorised as retail or professional investors under the FCA's new regulatory framework.

Over recent months charities with investments have been receiving letters from their investment managers advising them that they are being reclassified as either retail or professional investors.

The current categorisation model has been in place since November 2007, when it was introduced following the 2004 EU directive on Markets in Financial Instruments, and there has been no change since then. However, some investment managers are using the introduction of the new Retail Distribution Review (RDR) as a reason to review the categorisation of their charity clients.

Many trustees and their staff may think that as they hold professional qualifications, and as the charity is an "institution", they must therefore be professional investors. But that is a myth.

What does the term 'professional investor' actually mean for charities? The classification was created for sophisticated "high net worth" individuals who are comfortable with taking more responsibility for their investment decisions. Is this appropriate for a charity? Are Charity Trustees comfortable to forgo statutory protection? We also pose an ethical question: are some investment managers adhering to the 'letter of the law' but not to its intention in classifying their charity clients?

Our article also highlights the fact that there are no regulatory or legal changes which require any re-categorisation of charities as a result of RDR, and therefore we question the timing of the current campaigns.

The need for regulation

Trust in financial services has been eroded by the banking crisis and a series of miss-selling scandals, ranging from pensions and endowments to payment protection insurance and interest-rate hedging products. Regulators continue to seek ways to require firms to design financial products for the needs of customers, rather than just as a source of profit, focusing on protecting retail customers who are least well able to look after themselves.

When financial markets are rising, and investors are doing well, protection for investors is unlikely to be a priority and asymmetries of information between investors and investment professionals appear not to be terribly important. However, in *Asset Management and Investor Protection* (2003), Franks et al recognised that information asymmetry leads to two potential types of market failure, where the principle of 'caveat emptor' (let the buyer beware) is insufficient.

Firstly, adverse selection takes place when customers cannot distinguish between the quality of alternative products, and so providers of lower-quality products thrive at the expense of providers of higher-quality products (assuming that there is a cost to providing quality).

Secondly, moral hazard arises to the extent that providers may be tempted to act other than in the customers' interest.

It is very difficult to judge the quality of an investment before - or even after - purchase, except over the very long term. This increases the risk of market failure, since a firm's good reputation cannot be valued if quality cannot easily be determined.

The implication is that there is an important role for regulatory intervention, in order to guarantee a certain minimum level of quality in financial markets.

Development of a legal framework for investor protection

The late Sir Kenneth Berrill, the first chairman of the Securities and Investments Board (SIB), stated in a lecture in 1987 that, in the context of the sustained bull market of the mid-1980s, many market participants had found regulation introduced by the 1986 Financial Services Act to be "too detailed, too legalistic, and too expensive to implement".

Nevertheless, in a period of widening share ownership - not least from government privatisation campaigns - Berrill identified that, while compensation was obviously required for small investors in the event of specific fraud, losses could actually occur on a much broader basis through "hidden charges, conflicts of interest, bad advice, inadequate research, and straightforward incompetence". These types of loss were the prime focus of regulation by the SIB.

- **Principles-based regulation**

The SIB, which was established in 1985, and changed its name to the Financial Services Authority (FSA) in 1997, started with seven 'pillars' of investment protection. In 1990 they were expanded to become eleven *Principles for Businesses*.

Principles-based regulation (supplemented by rules) has been favoured in the UK to achieve flexible application in rapidly changing market environments and to reduce the scope for what some have termed 'creative compliance'. Principle six requires a firm to treat its customers fairly.

- **Rules-based regulation**

In 2004, as noted earlier, the European Union introduced the Markets in Financial Instruments directive (Mifid) to harmonise regulation across member states. Mifid applies a much more rules-based approach to certain types of financial transaction (which include discretionary portfolio management carried out by investment firms). It was brought into UK law in November 2007 by a combination of amendments to the Financial Services and Markets Act 2000 and other secondary legislation; and the various legislative definitions are now integrated into the FSA's *Conduct of Business Sourcebook*.

The Retail Distribution Review

Under discussion since 2006, the RDR came into effect at the start of 2013 within the legislative framework described above. By this means, the Financial Conduct Authority (the successor body to the FSA since April this year) is seeking to raise professional standards in the provision of advice about retail products to retail customers. Under this framework, advisers are required to hold specific qualifications; the basis on which financial advisers may describe themselves as “independent” is defined; and commission-based remuneration of advisers is outlawed in favour of explicitly disclosed fees.

Client categorisation

Under Mifid’s rules, there are now three clearly-defined categories of clients served by investment managers: “retail”, “professional” and “eligible counterparties”.

The impact of client categorisation is particularly felt through the obligations placed on an adviser by principle nine of the *Principles for Businesses* - which the FCA inherited from the FSA - in relation to “the suitability of its advice and discretionary decisions for any customer who is entitled to rely on its judgement”. Before doing business, an adviser must have assessed the retail customer’s financial situation, have confirmed their risk appetite and investment objectives, and have ensured that any investments made meet those requirements.

Principle six (a firm must treat its customers “fairly”) is also relevant, but - and most importantly for this article - both principles six and nine are applied in a slightly modified form, particularly as far as “suitability” is concerned, when dealing with “professional” clients.

Professional clients may be categorised on the basis of size alone (authorised financial market participants, large undertakings, governments or other institutional investors). Smaller organisations may elect to ‘opt up’ to professional status (through a process involving a quantitative test, a qualitative test, and some other procedures) so long as the investment firm acting for the organisation satisfies itself qualitatively that the client is capable of making its own investment decisions and that specific procedures are followed.

In the case of ‘opting up’, principle six requires the qualitative test to be applied by the investment adviser as objectively as possible, and not just on the basis of what is most commercially convenient for the firm concerned).

Transfer between categories need not be just one way. The customer always has the right to request to be treated as a retail client in order to benefit from greater protection, and the legislation places a responsibility on every professional client to request this change if, at any time, it believes that it is unable properly to assess or manage its investment risks.

It is crucial to note in the context of a large charity, that this is a responsibility of the charity, not of its advisers - so an awareness of this issue by charity trustees is very important. As a minimum, trustees of large charities should consider the non-size-related thresholds defined for elective professional investors (which include consideration of the frequency of transactions and the specific professional experience in the financial sector which trustees have).

Client categorisation in practice

We have conducted a survey among participants on the Cass MSc charity courses this year to look at how investment managers have been advising their charity clients about the changes described above which have been brought in by the RDR.

Unsurprisingly, what we have found is that the message is not the same for all charities, even where two charities use the same investment manager.

- **Case study** – Two charity clients have the same investment manager but did not receive the same letter advising them of the changes, although both charities were assured that they are valued customers.

Charity A has investments of some £15m.

On the basis of the client categorisation criteria, the investment manager has the right to treat charity A as being a professional investor because of the size of its balance sheet and investment funds ('per se professional'). At no stage has charity A been advised about the categories or their options by the manager.

However, it is entirely the investment firm's choice whether or not it wishes to provide advice regarding categorisation to its client in the form of recommendations (which will result in client protection), so the investment manager is acting entirely within the 'rules' when they classify charity A as a professional client.

The only difference between retail and professional clients is that the adviser may assume that a professional client has the necessary level of experience and knowledge and - in the case of a 'per-se-professional client' - is financially able to bear any related investment risks, consistent with its investment objectives.

However, charity A may request to be treated as a retail client if it sees fit. Although the trustee board at present includes a range of commercial experience - including an investment manager and an investment banker - and this does appear to represent an appropriate degree of expertise, if "professional client" status is to be retained the charity must always ensure that it has such expertise and that the "professional" trustees attend every meeting.

Charity B has investments of £2m. The letter it received from its fund manager gave notice that the manager was refining the services that it offered to "charities such as you". The manager would now no longer be able to provide their discretionary investment management service since charity B had been classified as a "retail" client; an alternative pooled fund could however be invested in without the manager's advice or discretionary service.

While the letters received by the two charities are both 'within the rules' it is somewhat ironic that the larger charity – clearly one the investment manager really wants to keep as a client - is being offered a service where it will lose regulatory protection.

It appears that the fund manager concerned has chosen to pursue a business model serving professional clients only. Many other investment firms are doing the same thing, particularly if

they are not licensed to deal with retail clients. This may be a legitimate business decision, usually made on cost grounds, because the manager does not wish to invest in the regulatory systems, staff training and qualifications that would be required to obtain a licence permitting the firm concerned to give investment advice.

However, we have to ask this question: is it right that an investment manager's own business priorities can trigger a reassessment of a client's categorisation? Nothing has surely changed as far as the client itself is concerned.

Different classification by other firms

Other investment managers take a different approach. For example, three of the top ten charity investment managers, ranked by assets under management in *Charity Finance's* Charity Fund Management Survey, are initially classifying all their charity clients as "retail" as a matter of course, and regardless of size.

The lack of reference to size suggests that these fund managers take the view that charities do not have the market understanding and expertise to be treated as professional clients; though strictly unnecessary, it would seem harsh for them to be criticised for offering their clients additional protection.

However, we found that some charities - where there is considerable investment expertise on their trustee board - were initially unaware of their categorisation, and then when they learned about it they were surprised that their investment manager had classified them as a retail client, which some regarded as wholly unnecessary protection. For example very large charities which are clearly institutions or for those where the trustees feel confident that they would like to directly invest in asset classes that they have an expertise in.

Elective professional status

There might be a scenario where some charity clients, which are not 'per se professionals', are encouraged to 'opt up' to professional status, perhaps by the offer of reduced fees. While we found no such examples, some fund managers reported suspicions to us that their competitors may be doing this.

In contractual terms, such an offer might initially appear to be reasonable: well-informed charity trustees being offered a transaction under the terms of which they would pay a lower price but receive a lower set of protections, and being free to judge the trade-off.

However, the key assumption here is that the charity concerned has the competence and capability to take such a decision, and the existence of asymmetric information is precisely the reason for regulatory intervention. The investment manager has an obligation to its retail client under principle nine referred to earlier, and must properly apply the qualitative test of the client's expertise.

There is a strong case for asserting that any initiative taken to encourage a retail client to opt up is in breach of principle nine, even if the required process and procedure have been followed.

Implications for charity trustees under charity law

Charity Commission guidance in *Charities and Investment Matters* (CC14) requires trustees to exercise a duty of care when making investment decisions. This will include drawing on their personal knowledge and satisfying themselves that investments are appropriate.

The Commission concludes in CC14 that where trustees “have considered the relevant issues, taken advice where appropriate and reached a reasonable decision, they are unlikely to be criticised”.

The CC14 guidance is derived from trustee obligations under the Trustee Act 2001. The Act defines investment criteria in terms of suitability and portfolio diversification, and requires that “a trustee must (unless the exception applies) obtain and consider appropriate advice” from a suitably qualified person in relation to the investment criteria.

The exception referred to here is “that a trustee need not obtain such advice if he reasonably concludes that in all the circumstances it is unnecessary or inappropriate to do so”. The trustees’ reasonable duty of care includes “having regard, in particular, to any special knowledge or skill that he has or holds himself out as having”.

One might reasonably infer from this combination of provisions that trustees of charities which are considering investment should only forego professional advice from external investment advisers where they are confident that one or more of the trustee body (or paid staff) has equivalent experience and expertise. Furthermore, where a charity acts on the advice of one or more trustees, CC14 makes it clear that they are responsible (in the same way as any other adviser) for the quality of their advice, and ultimately liable to the charity for any losses incurred in the event that the advice turns out to have been either poor or negligent.

A charity which allows itself to be categorised as a professional investor is therefore forfeiting some protections with respect to the suitability of its investments. In the event that its fund manager’s investment advice was negligent, the charity has no right of redress in terms of compensation other than from its own trustees, in relation to the complaints procedure set out in the FCA handbook. However, it could pursue a claim under contract or in tort against the firm in a civil court of law.

It is clear that whatever the size of its investment portfolio, every charity would be well advised to understand how it has been categorised under the new RDR framework by its fund manager. Having established whether you are a retail or a professional client, you need to understand the implications and assess whether that categorisation best suits your needs. A charity moving to professional status needs to ensure it has the expertise and that they will maintain it, rather than accepting Professional status without advice.

An investment checklist for trustees

A one-size-fits-all approach is almost never appropriate within the charity sector and investment matters are no exception. However, there are a few conclusions which all charity trustees may wish to consider:

- Since many charities (especially those with endowments) will pass the quantitative test to be treated as 'per-se-professional' investors, charities should make themselves aware of how they have been categorised by their fund managers.
- If a charity has been categorised as professional but trustees doubt their investment expertise, they should request treatment as a retail customer to obtain 'quasi-fiduciary' protection.
- If a charity has been categorised as retail but is encouraged to 'opt up', it should take great care, recognising that its fund manager may be in breach of regulatory procedures.
- If a charity has been categorised as professional, those trustees deemed to have given advice are potentially liable in the event that their advice proves to have been poor.
- Charities should be clear on the reasoning behind any change in their categorisation. Any change should be based on a change in their circumstances and not on any change in the business model followed by their investment manager.

Andy Butterworth is bursar at Wycliffe Hall, a private hall of the University of Oxford

Professor Paul Palmer is associate dean for ethics and director of the Centre for Charity Effectiveness at Cass Business School, City University, and London.