SimplyBiz Group

SIGNATURE

GUIDE TO BEING A DISCRETIONARY INVESTMENT MANAGER (DIM)

This guide highlights the rules and guidance of the Financial Conduct Authority that are specifically aimed at firms that perform discretionary management activities.

We will cover the areas that we feel are crucial for firms who perform discretionary management activities.

Capital Resource Requirements

Having adequate resources, including financial resources, is one of the core threshold conditions that all firms are required to meet in order to maintain FCA authorisation.

DIM firms are subject to higher capital resource requirements than other intermediary firms and they are also subject to more onerous rules surrounding the monitoring of their capital resources.

This is because DIM firms fall within the scope of MiFID and are subject to the Capital Requirements Directive (CRD).

The 'minimum capital resource requirement' is the minimum amount of capital that a DIM firm is required to hold.

The minimum capital resource requirements for a BIPRU firm will be the higher of -

The base requirement

The base capital resource requirement for a DIM firm that holds discretionary investment management permissions but does not have permission to hold client money or assets for investment business or to deal for own account is €50,000.00.

The base capital resource requirement is the lowest amount of capital that a firm can hold. Regardless of whether the sum total of its credit risk and market risk calculation, or the fixed overheads requirement calculations, produces an amount below this figure, the base capital resource figure of €50,000.00 will apply.

The sum total of the deemed 'credit' and 'market' risk requirements

Credit Risk is the risk of loss due to a debtor's non-payment of monies owed at a stipulated time. If your firm is subject to credit risks, you will need to calculate the minimum capital required to cover your credit risks.

Market risk is the risk of losses in on and off balance sheet positions arising from movements in market prices. BIPRU 7 sets out the detailed rules and guidance on the market risk capital requirements.

We believe that the majority of Signature BIPRU firms are unlikely to be exposed to either 'credit' or 'market' risks, as these risks primarily relate to firms that hold positions in investments themselves.

The Fixed Overheads Requirement

The fixed overheads requirement (FOR) is likely to be the calculation that determines the minimum capital resource requirement for a DIM firm.

In relation to a BIPRU investment firm, which is required to calculate a fixed overheads requirement, the amount of that requirement is equal to one quarter of the firm's relevant fixed expenditure calculated in accordance with GENPRU 2.1.54 R.

A BIPRU investment firm's relevant fixed expenditure is the amount described as total expenditure in its most recent audited annual report and accounts, less the following items (if they are included within such expenditure):

- staff bonuses, except to the extent that they are guaranteed
- employees' and directors' shares in profits, except to the extent that they are guaranteed
- shared commission and fees payable which are directly related to commission and fees receivable, and are included within total revenue
- interest charges in respect of borrowings made to finance the acquisition of the firm's readily realisable investments
- interest paid to customers on client money
- interest paid to counterparties
- fees, brokerage and other charges paid to clearing houses, exchanges and intermediate brokers, for the purposes of executing, registering or clearing transactions
- foreign exchange losses
- other variable expenditure

Fixed expenditure is likely to include most salaries and staff costs, office rent, payment for the rent or lease of office equipment and insurance premiums.

Definition of 'capital resources'

Having determined the amount of capital to be held through calculating the minimum capital resource, a DIM firm will need to establish the types of capital resource that can be used to meet the minimum capital resource requirements.

The FCA has divided its definition of capital into categories reflecting differences in the extent to which the capital instruments are considered reliable.

The FCA generally prefers a firm to hold higher quality capital that meets the characteristics of permanency and loss absorbency that are features of 'tier one' capital. Capital instruments falling into core tier one capital can be included in a firm's regulatory capital without limit.

Other forms of capital that fall outside of tier one capital are either subject to limits, or, in the case of some specialist types of capital, may only be included with the express consent of the FCA.

Tier one capital

Tier one capital, which is the highest quality capital, has the following characteristics:

- it is able to absorb losses
- it is readily realisable
- it ranks for repayment upon winding up, administration or similar procedure after all other debts and liabilities
- it has no fixed costs i.e. there is no obligation to pay dividends or interest

The forms of capital that qualify for Tier one capital are set out in the relevant capital resources table and include, for example, share capital, reserves, partnership and sole trader capital and verified interim net profits.

Tier two capital

Tier two capital includes forms of capital that do not meet the requirements for permanency and have an absence of fixed servicing costs that apply to tier one capital.

Tier two capital includes, for example certain revaluation reserves, such as reserves arising from the revaluation of land and buildings, including any net unrealised gains for the fair valuation of equities held in the available-for-sale financial assets category.

Tier three capital

Tier three capital consists of forms of capital conforming least well to the characteristics of capital listed in GENPRU 2.2.9 G either subordinated debt of short maturity (upper tier three capital) or net trading book profits that have not been externally verified (lower tier three capital).

Internal Capital Adequacy Assessment Process (ICAAP)

Under Pillar 2, a firm must, amongst other things, regularly assess the amount of internal capital it considers adequate to cover all of the risks to which it is exposed within the context of its overall risk management framework. The process is known as the Internal Capital Adequacy Assessment Process (ICAAP).

GENPRU 1.2.26 R states that 'a firm must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both in terms of amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due'.

GENPRU 1.2.30 R which is commonly known as the 'Overall Pillar 2 rule' states that a firm must have sound and effective processes, strategies and systems in place.

Through undertaking an ICAAP process a firm may establish that they need to hold greater levels of capital than the minimum capital resource calculation (under Pillar 1) if through quantifying its risk exposures this produces a higher level of capital than the minimum capital resource calculation test.

Firms do not actually have to submit their ICAAP to the FCA but they must regularly report that it is being undertaken.

Best execution rules

The best execution rules require firms, when executing, placing or transmitting orders in financial instruments, to act in accordance with the best interests of its clients and in particular take all sufficient steps to obtain the best possible result for its clients. Where a firm chooses not to provide clients with a copy of its Best Execution policy, then it is required to provide clients with appropriate information on their policy.

Locum arrangements

Unless you have more than one qualified experienced investment manager within your firm, there should be a locum arrangement in place so that your firm and its clients would have access to another suitably qualified experienced individual in the event of your investment manager's long-term absence. It would be best practice for this individual to also sit on your Investment Committee.

Client Documentation

Client Agreement

We would recommend using a separate agreement to the normal advisory business agreement, to avoid client confusion. This is essentially a formal two-way agreement setting out the rights and obligations of both parties and would include your scope of discretion, investment objectives, client assets (if appropriate), dealing, instructions, client reporting and rights.

Investment Mandate

This needs to contain the instructions to guide your investment manager in the management of a client's investments and would include the investment objective, constraints, permitted investments, restricted investments, counterparty restrictions, delegation and reporting.

Client Reporting

There are two different standards in operation depending on whether your firm is reporting on MiFID financial instruments or designated investment business other than MiFID business. We would recommend that for consistency you should report to clients according to the requirements for MiFID business as it is subject to higher standards.

If your firm is managing investments on behalf of a client, it must provide the client with a periodic statement in a 'durable medium'. The periodic statement should provide a fair and balanced review of the activities undertaken and of the performance of the portfolio during the reporting period and should include the following information -

- the name of your investment firm
- the name or other designation of the client's account
- a statement of the contents and the valuation of the portfolio, including details of each financial instrument held, its market value, or fair value if market value is unavailable and the cash balance at the beginning and at the end of the reporting period, and the performance of the portfolio during the reporting period
- the total amount of fees and charges incurred during the reporting period, itemising at least total management fees and total costs associated with execution, and including, where relevant, a statement that a more detailed breakdown will be provided on request
- a comparison of performance during the period covered by the statement with the investment performance benchmark (if any) agreed between the investment firm and the client
- the total amount of dividends, interest and other payments received during the reporting period in relation to the client's portfolio
- information about other corporate actions giving rights in relation to financial instruments held in the portfolio;

The periodic statement referred to above should be provided to the client once every three months.

10% reporting requirements for MiFID business

Where a client's investment is managed on a discretionary basis, the client must be notified where the value of their portfolio reduces by 10% or more. MiFID II brought in a requirement for discretionary managers to provide quarterly reporting to investors. At the start of these quarterly periods, the overall portfolio valuation must be recorded and if its value drops by 10% (and each 10% thereafter) at any time before the start of the next reporting period, the client must be notified by close of business the same day.

There is no requirement to report 10% portfolio drops for designated investment business other than MiFID business. However, the rules do require that a firm that manages investments for a retail client should report any losses that exceed any predetermined thresholds agreed between the firm and the client. Where a predetermined threshold has been agreed the firm must report no later than the end of the business day in which the threshold is exceeded.

Remuneration Code

The Remuneration Code applies to all firms holding investment management permissions. The rules are intended to ensure that your remuneration (bonuses etc.) does not affect your advice, investment activity or how you treat your clients' assets. For example, unnecessary switching or dealing where you charge or are remunerated for the service, or where advisers receive bonuses based on quantity rather than quality of the advice or service.

Your firm must establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management, these should be proportionate to the nature, scale and complexity of your activities.

Overseer role for administrative functions in relation to managing investments

Managing investments means that you will also be administering investments and carrying out

administrative functions in relation to managing investments (e.g. client account administration,

including valuation and performance measurement); these activities require an overseer.

There is a qualification requirement for this activity (Activity number 17 in TC Appendix 4.1 which is covered by 3 papers of the Investment Administration Qualification, but the activity can be commenced before an individual is fully qualified, provided you are satisfied that the individual is competent in the role. The role would not be particularly onerous and the current qualification requirements for managing investments exceeds this, so could also be carried out by your investment manager.

Conduct of Business and Systems and Controls requirements

The FCA's conduct of business (COBS) rules and systems and controls (SYSC) rules are more onerous for firms coming within the scope of MiFID.

- The managing investments activity applies to your firm as a whole and will introduce the need for you to put in place appropriate procedures and processes. This will require changes to your compliance and T&C processes, in terms of monitoring activity, conduct of business and systems and controls. You should consider who will supervise the investment manager and whether they have the appropriate experience and qualifications.
- MiFID firms are generally subject to increased retention periods for records (from 3 to 5 years) and you will have a greater scope of records to cover in respect of discretionary transactions conducted on behalf of customers.
- Suitability issues – Moving to discretionary investment management does not remove any obligation from your firm to ensure suitability. You will need to obtain and record sufficient client information at the outset (and on an ongoing basis), including attitude to investment risk, in order to demonstrate adherence to the 'know your client' requirements.
- Taping of telephone conversations – As discretionary investment management firms are in scope of MiFID you will need to tape conversations over the phone that relate to client orders in MiFID financial instruments. The phone conversations that are relevant are those that are intended to lead to an investment transaction taking place for financial instruments. Article 3 firms have the choice of taking a written note of these type of phone conversations.
- Best execution – Your firm will need to maintain records of the execution venues you have used and publish the results annually on the top five venues you have used in the preceding year on your website.

Legal Entity Identifier (LEI) codes

By holding discretionary investment management permissions, your firm will be required to hold an LEI code. This is because your firm is in scope of the MiFID transaction reporting rules. Even where your firm can claim an exemption from these reporting requirements the firm to whom orders are transmitted will need to identify the 'decision maker' (your firm) for any transactions.

Audits

Annual audits are a requirement for discretionary investment management firms. You need to make sure your auditors are competent with regard to financial services regulation in general and MiFID audit requirements in particular.