Notification and justification for amending certain requirements relating to the market for packaged products under Article 4 of Directive 2006/73/EC ("Level 2 Directive") implementing Directive 2004/39/EC ("Level 1 Directive")

This amendment relates to FSA Handbook text published on 26th March 2010, as part of the Financial Services Authority's "Retail Distribution Review".

1. The UK previously notified the Commission of its requirements on firms relating to the market for packaged products, regarding:

   a) the accuracy of representations about the nature of the service offered;

   b) information about products; and

   c) information about the costs of services.

2. We are proposing some changes to our policy approach in regard to **a)** and **c)** and, as a result, plan to update our notifications under Article 4 as explained in this paper. In order to be clear about precisely what changes we are making, we are not revoking our previous notifications[1], but will set out amendments to them in this paper.

3. Unless otherwise indicated, references in this paper to new requirements relate to the Retail Distribution Review (Adviser Charging) Instrument 2010 made by order of the FSA Board on 25th March 2010.

Update to Section 1: background description of the relevant UK market and risks

4. Our previous notification explained how, at present, the UK uses the description "packaged products" to mean units in regulated collective investment schemes (which include units in UCITS and certain non-UCITS retail schemes), shares in investment trusts (in certain situations)[2], life assurance policies with an investment component and certain types of pension product. Our "packaged product" rules currently apply in regard to all of these products, reflecting the widespread substitutability in the UK of investments that are within the scope of MiFID and those that are not.

5. At the time of our previous notification, the Commission had already highlighted the risk that differential regimes in such circumstances run the risk of competitive distortion, and this point is now being explored further through the Commission's work on Packaged Retail Investment Products[3].

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[1] '*Notification and justification for retention of certain requirements relating to the market for packaged products under Article 4 of Directive 2006/73/EC ("Level 2 Directive") implementing Directive 2004/39/EC ("Level 1 Directive")'* is available from HM Treasury together with the UK's notification relating to the use of dealing commissions (please see from page 10 onwards of the document, currently available at: http://www.hm-treasury.gov.uk/d/mifid_article4_notification170907.pdf)

[2] As explained in our current notification, investment trusts are only treated as packaged products when sold through a dedicated service, as opposed to a more general equity brokerage service

[3] '*Communication from the Commission to the European Parliament and the Council: Packaged Retail Investment Products*', 30 April 2009; '*Update on Commission work on Packaged Retail Investment Products*', 16 December 2009, http://ec.europa.eu/internal_market/finservices-retail/investment_products_en.htm

6. With this in mind, we have given further consideration to recent product developments in the UK market, and have observed the increasing substitutability of certain products outside our current definition with those that we do classify as "packaged products". We propose to modernise our current approach, applying the amended rules discussed in this paper slightly more widely to cover "retail investment products" more generally, including structured retail investment products, unregulated collective investment schemes (including those that are exchange traded) and those investment trusts not currently captured, as well as the products that we currently classify as "packaged products". This change seeks to reflect the overall approach put forward by the Commission in its Packaged Retail Investment Products work.

Developments in retail investment products

7. The need to cover this wider range of products is demonstrated by their growing importance in the market:

   - Structured products have been a popular choice for investors looking for security for their capital investment in the difficult market environment. There is no single, uniform definition of a structured product but a common feature is a guarantee offered on the capital invested if held to maturity. According to Arete Consulting, the total UK retail structured products market is worth around £35bn[4], comprising approximately 116 products available to UK investors. Sales have increased from £5,449m in 2003 to £8,120m in 2008. Banks are the main distributors of structured products, but recently increased sales by independent financial advisers may have been driving the higher volumes of structured products sales.

   - Investment trusts are listed companies that invest in a wide variety of securities, but at present they are frequently not considered as "packaged products" because they are sold through general equity brokerage services. In September 2008, the Association of Investment Companies, the trade body that represents the majority of listed investment trust companies reported that there were 451 listed investment companies in the UK, with a total market capitalisation of £62bn and a total net asset value of £89bn (around 97% of which was investment trusts). There were 10,000 investment trust sales in the UK in 2007/08 while the value of investment trusts held through individual savings accounts (ISAs) has increased from £1,583m in 2004 to £2,087m in 2008[5].

Structure of the UK market: distribution and associated risks

8. In our current notification we explain, in some detail, the structure of the UK market, including the significant reliance of UK consumers on personal recommendations from advisers (both as part of independent and non-independent advice services) and the problem of so-called 'principal/agent' risks, which can arise from the way in which advisers are remunerated in the UK market and can lead to risks of bias in recommendations made to clients. These structural factors remain of significant

[4] GBP denominated products only; not including institutional, offshore or private banking. Arete Consulting provides paid-for data via its website, www.structuredretailproducts.com

[5] *Saving and Investing for the Long Term*, Mintel, February 2009

relevance in the UK, and we now aim to introduce more effective tools for tackling the risks already identified:

- *reliance of UK consumers on personal recommendations:* as identified in our current notification, UK consumers continue to rely on advisers to a greater extent than in many other member states, receiving independent or non-independent advice in a significant majority of cases. For example, in the period April 2007 to March 2008 almost two thirds (64%) of all retail investment product sales were on an advised basis[6].

- *principal/agent risk present in the UK:* the risk of remuneration bias distorting advice, explained in our current notification, remains of great concern in the UK. For example, research from CRA International commissioned by ABI found evidence of bias to recommend a particular type of product and also bias to recommend particular providers depending on the commission paid[7]. More recently, the Chairman of the Financial Services Consumer Panel reported on industry research showing that "firms can achieve a 70% increase in sales by a 10% increase in commission"[8], which indicates the continuing scale of the problem.

9. Given the continuing importance of these structural factors, it is important for us to attempt to tackle the issues identified in our current notification as effectively as possible. The arguments below reflect and explain our reasons for pursuing different approaches to those in our original notification, highlighting the evidence we now have that alternative approaches are more likely to be effective, or are now more viable than in the past.

Update to Section 2: the requirements covered by this notification

A – The accuracy of representations about the nature of the service offered

Amending our approach to the way that firms that give personal recommendations describe their services

10. At present, our rules specify two conditions that firms must meet if they wish to hold themselves out at 'independent' – a firm may only do so if it: a) advises on products from the whole market (or the whole of a market sector) (the "**whole of market requirement**"); and b) offers its clients the opportunity to pay for the advice solely by fee and, if a client chooses to do so, transfers to the client the value of any commission received (the "**fee option requirements**").

11. We now plan to move away from our current fee option requirements as part of a wider change to our approach to dealing with the risk of recommendations being

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[6] *Retail Investments - Product Sales Data Trends Report*, FSA, September 2008, available at http://www.fsa.gov.uk/pubs/other/psd_trends_invest.pdf. Retail investment products covered in the data include pensions (personal, occupational, annuities and income drawdown), investment bonds, unit trusts, OEICs, investment trusts, structured capital-at-risk products, endowments, equity ISAs, and long-term care insurance.

[7] *Study of intermediary remuneration: A report for the Association of British Insurers,* CRA International, February 2005 (commented on by the author at http://news.bbc.co.uk/1/hi/programmes/moneybox/4545811.stm)

[8] Research from the Association of British Insurers referenced by John Howard, FSA Annual Public Meeting, July 2007 http://www.fsa.gov.uk/pages/Library/Corporate/Meetings/howard_07.shtml

biased as a result of the receipt of commission. In the next section of this paper we set out our new overall approach to information about the costs of services. (In the light of the changes we are proposing in the next section, we no longer anticipate that it will be proportionate to maintain a separate fee option requirement in relation to independent advice – please see the next section for further information on this.)

12. To address the risk of clients not understanding the nature of the service they receive, it remains important for us to set out, explicitly, what is required from firms that hold themselves out as "independent". However, consumer research indicates that the current advice framework in the UK remains characterised by a good deal of confusion[9]. Consumers participating in this research initially referred to any advice they received as being received from an independent financial adviser, even when provided by a tied bank employee. The absence of any consistent terminology for non-independent firms to use to describe their advice may have contributed to this particular area of confusion, as consumers receiving non-independent advice from tied bank employees would not specifically be told that they were receiving restricted advice.

13. To deliver a clearer distinction for consumers between independent advice and other, restricted forms of advice, our amended rules require that firms giving personal recommendations on investments to retail clients make clear in a durable medium or through a website if the website conditions are satisfied, using the following terms, whether their advice will be:

- "independent" if they base their personal recommendations for each client on a comprehensive and fair analysis[10] of the relevant market[11], which is both unbiased and unrestricted (a "**requirement to analyse the market comprehensively and fairly**") – this is similar to our current whole of market requirement; **or**
- "restricted", in which case they would need to make clear the nature of the restrictions on their service ("**requirement to make clear that advice is restricted**") and, where the firm engages in spoken interaction, disclose this orally.

14. Following on from these requirements, if a firm offers both types of services we would also require it to make the differences clear and it would not be allowed to hold itself out as acting independently for its business as a whole.

15. This amended approach is designed to strengthen the distinctions between services available, to address the risk of consumers being misled about the services on offer. The updated approach, requiring firms to analyse the market comprehensively and fairly, also reflects the innovation and development that has occurred in the UK market. As many firms are choosing to adopt business models that involve performing

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[9] *Exploration of consumer attitudes and behaviour with regard to financial advice and the implications of RDR proposals*, commissioned from GfK by the Financial Services Consumer Panel, January 2008 (available at http://www.fs-cp.org.uk/pdf/rdr_report.pdf)

[10] This would also bring our requirements more closely into line with language used in the Insurance Mediation Directive (Directive 2002/92/EC) - Article 12 describes the standards an insurance intermediary must meet when he informs the customer that he gives his advice on the basis of a fair analysis

[11] Where a firm provides independent advice in respect of a "relevant market" that does not include all retail investment products, the firm would be required to set out an explanation of its relevant market

some aspects of research and analysis centrally, rather than reviewing the whole market for each client individually, the new approach is designed to be more meaningful and appropriate, and also more easily communicated to firms than our current whole of market requirement.

In what way would the amended requirements be additional to those in the Level 2 Directive?

16. Our amended requirements fit with the Directive in broadly the same way as our current requirements. Articles 19(2) and (3) of the Level 1 Directive, together with the Level 2 provisions implementing them, require firms to inform clients about their services in a way that is fair, clear and not misleading and with appropriate information in a comprehensible form. The requirements to analyse the market comprehensively and fairly and to make clear that advice is restricted can be seen as an application of these principles to the way in which the concept of an independent adviser is generally understood in the UK market. We therefore believe our approach is entirely compatible with MiFID requirements for firms to provide appropriate information on their services in a comprehensible form.

17. As under our current approach, the amended requirement does not seek to create distinct investment services of firms that are 'independent' or ‘restricted’, but seeks to ensure that particular distribution models are correctly represented and understood, in a way that our consumer testing has indicated that consumers can understand. We therefore continue to notify our amended rules in this area on a precautionary basis, in case they are deemed to impose additional requirements beyond the Level 2 measures implementing Article 19.

Specific risks to investor protection not adequately addressed by the Level 2 Directive

18. As with our current notification, our amended requirements seek to address the risk of clients not understanding the nature of the services they receive, reflecting the evidence of our consumer research that significant consumer confusion remains at present. In addition, we believe that the requirements to analyse the market comprehensively and fairly and to make clear that advice is restricted are consistent with MiFID, and that it provides greater certainty for firms in the UK if the FSA has clear rules on this point.

19. The high level "fair, clear and not misleading" principle in Article 19(2) of the Level 1 Directive and the requirement for “appropriate information … in a comprehensible form” in Article 19(3) set out the principles that firms need to meet, but in practice there is a need for effective and consistent application of these principles in the UK market, to tackle the risk of investor misunderstanding remaining.

20. Our original notification explained how earlier regulations in the UK limited the services that adviser firms could offer and created a strong focus on the question of whether or not firms offer “independent” advice. With this in mind, we felt the need to retain rules relating to the definition of “independent”. However, we now believe that the absence of a defined term for non-independent advice may also be causing confusion, as firms that provided restricted services can simply avoid the question of whether their services are independent. Research has highlighted the practical problem that independent financial adviser – or ‘IFA’– is ‘a handy catch-all term to

refer to financial advice'[12], supporting the need for an equivalent, standardised description for non-independent advice.

21. Our approach continues to reflect the importance of independent advice, with the introduction of requirements relating to the term "restricted advice" reflecting the need for consumers to understand whether any advice on offer to them is independent or restricted. The significant risks associated with poor consumer understanding, and the challenges associated with financial capability in the UK[13], mean that it will be important for the FSA to raise awareness of the types of advice – and for this purpose having standardised terminology for both services is essential.

In what way are the risks of particular importance in the circumstances of the market structure in the UK?

22. Our current notification under Article 4 includes information about the market structure operating in the UK and, in particular, highlights both the reliance of consumers on advisers, for independent or restricted advice, and the difficulties that consumers face in understanding the different services on offer to them. This is further supported by the more recent consumer research, referenced earlier, which evidences our concern that the consumer confusion about the current advice framework in the UK remains significant.

23. The structural issues we have identified create significant obstacles to consumers receiving information that will reasonably enable them to understand the nature and risks of the investment services they engage. These circumstances continue to drive our approach to the way that firms that give personal recommendations should describe their services. Our amended approach is designed to better reflect and deal with the risks to consumers, introducing a corresponding requirement relating to non-independent advice to better tackle the problems of consumer understanding that have arisen in the UK advice market.

Why is this approach proportionate?

24. This approach recognises concern in the UK that consumers are currently unable to effectively distinguish between independent advice and alternative services on offer to them, despite earlier attempts to achieve this. In reinforcing the MiFID principle that firms must communicate in a manner that is fair, clear and not misleading, the amended requirements do not involve significant additional burdens for firms.

25. Rather than attempting to deal with the risk of consumers being misled about the services on offer by placing restriction on the business models that firms can provide, the amended requirements offer a proportionate approach to achieving the outcome envisaged in Articles 19(2) and (3). The requirement to analyse the market comprehensively and fairly only applies where firms choose to advertise or conduct

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[12] *Exploration of consumer attitudes and behaviour with regard to financial advice and the implications of RDR proposals*, commissioned from GfK by the Financial Services Consumer Panel, January 2008 (available at http://www.fs-cp.org.uk/pdf/rdr_report.pdf)

[13] See for example *'Levels of Financial Capability in the UK: Results of a baseline survey'* prepared for the FSA by Personal Finance Research Centre, University of Bristol in March 2006, available at http://www.fsa.gov.uk/pubs/consumer-research/crpr47.pdf

their services under a particular label, meaning that firms are given the flexibility to operate their business on other models if they choose. We commissioned IFF Research to conduct qualitative consumer research aimed at identifying possible labels for non-independent advice that might be effective in communicating to consumers the restricted nature of the advice, before bringing forward the requirement to make clear that advice is restricted[14].

The rights of investment firms under Article 31 and 32 of Directive 2004/39/EC

26. As with our current notification under Article 4, these requirements would not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive. This is because the FSA will not apply them to firms exercising rights under Article 31 and will only apply them to firms exercising rights under Article 32 in the circumstances contemplated in Article 32(7).

C – Information about the costs of services

Amending our approach to dealing with the risk of recommendations being biased as a result of the receipt of commission

27. Our current approach to addressing the risk of bias attempts to place significant reliance on the role of commission disclosure in tackling principal/agent problems in the UK advice market. Section C of our current notification contains a requirement relating to information about the costs of services, whereby we make firms disclose, explicitly, the amount of commission they receive in connection with a transaction or, where the firm is in the same immediate group as the product provider, they disclose a comparable figure known as 'commission equivalent' (the "**requirement to disclose hard commission or commission equivalent**"). As already mentioned, we also place a related requirement on firms describing themselves as independent to offer consumers the option to pay by fee instead of commission.

28. Overall, this approach has not been successful in the way that we had hoped at reducing the focus of competition in the industry on the amounts of commission paid to investment intermediaries by product providers (leading to product bias or provider bias). Developments in remuneration mechanisms available from the industry have also occurred, which make alternative options for dealing with the risk more viable, and as a result we are proposing to amend our approach to dealing with the risks of recommendations being biased as a result of the receipt of commission.

29. We now seek to tackle the risk of product provider remuneration bias much more simply and directly than under our current, disclosure-based approach. Our new approach is to require that a firm must only be remunerated for making a personal recommendation to a retail client (and any other services provided in connection with it) by charges agreed between itself and the client (a "**requirement for adviser firms to determine their own adviser charges**"). Adviser firms would not be allowed to solicit or accept other commissions (or other payments or benefits) in relation to giving a personal recommendation, even if they intended to pass the benefits on to the client, and regardless of whether the product they were recommending was

[14] *Describing advice services and adviser charging* (June 2009) www.fsa.gov.uk/pubs/consumer-research/crpr78.pdf

manufactured inside or outside of the UK. Firms could, however, receive adviser charges in the form of deductions from their clients' investments.

30. This new approach is similar to the fee option requirement described earlier, which we currently apply to adviser firms that describe their services as 'independent'. However, under the new requirement proposed – which would apply to all adviser firms, whether or not they offered independent advice[15] – firms can agree with their clients a range of different mechanisms for collecting their charges. This includes being able to have the charges deducted from clients' investments, similar to the current system whereby product providers deduct commissions from clients' investments to pay to advisers, ensuring consistency with the Directive.

31. Our concerns about the potential for commission to bias advice are by no means confined to the independent advice sector. Various past mis-selling cases in the UK have involved some firms in non-independent advice channels, including cases relating to precipice bonds, mortgage endowments and life assurance bonds. For example, we previously fined a bancassurer in regard to investment advice that was overly concentrated on particular products, as well as writing to the chief executive officers of firms that had previously been appointed representatives about a potentially inappropriate concentration of recommendations[16]. This case also provides an example of the substitutability, for many consumers in the UK, of different types of investment products (such as ISAs and life assurance bonds), highlighting the risk of remuneration bias occurring that relates to the *type* of product a firm recommends (which may arise even when a firm is advising from amongst the products of a single product provider). This reinforces the relevance of our proposals for non-independent advice as well as for independent advice.

32. In order to counter the principal/agent problems that exist in the UK, which create significant risk of advice being biased by commission, our new requirements are designed to ensure that, regardless of the type of advice being offered, a firm's remuneration would not be determined by the product provider that it recommended a product from. Adviser firms would no longer be able to recommend any products that automatically pay them particular commissions, in association with making the recommendation.

33. This approach to charging is described as 'adviser charging' in our new rules. It is designed to deliver a more effective approach than is achieved under our current rules to tackling the potential for commission payments to bias advice. Unlike with the current fee option requirement relating to 'independent' advice, firms will have choice, in practice, as to how they receive payment (for example, where their current practices do not risk creating bias, a commission-based firm could be remunerated on an equivalent basis to the present situation, receiving a percentage of a client's investment in return for their services).

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[15] For the avoidance of doubt, the UK wishes to make clear that its new requirements relating to adviser charging would alter the obligations on firms that give advice rather than amending the definition of advice, set out in MiFID. So, for example, MiFID-driven conduct of business requirements, such as those on the suitability of advice, would apply even if the firm breached these additional requirements relating to adviser charging.

[16] A 'Dear CEO' letter on a review of former appointed representative firms, July 2003, is published at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_25jul03.pdf

34. Our adviser charging requirements are designed to create a more effective solution to the principal/agent problems in the UK investment advice market, which we currently attempt to address through our requirement to disclose hard commission or commission equivalent. (This amendment to Section C of our notification applies only in relation to services that involve retail clients receiving a personal recommendation on retail investment products. We do not propose to amend Section C of our notification in relation to non-advised services, where we believe our existing rules on disclosure of commission and commission equivalent are more appropriate.)

Additional supporting requirements

35. As a corollary to the requirement on adviser firms, we will also place a requirement on UK firms that provide retail investment products[17] to retail clients that bans them from offering predetermined amounts of commission (or other payments or benefits) to UK adviser firms in relation to recommending their products. This will ensure that our rules tackle both the inappropriate payment and the inappropriate receipt of provider-determined commissions (an "**equivalent requirement on product providers**"), mirroring the general approach of Article 26 of the Level 2 Directive, which applies both where firms pay and where they are paid fees and commissions.

36. To achieve effective delivery of this approach, we would also introduce a number of supplementary rules to make sure that particular practices do not undermine our new approach ("**requirements relating to the practical application of adviser charging**"). These are included in this notification for completeness, but relate directly to the requirements already discussed:

- where a firm is offering a personal recommendation to a retail client, it must:
    - not set or operate an adviser charging structure that is likely to conceal the amount or purpose of any of its adviser charges from a retail client, and must not recommend a product with charges presented in such a way as to appear to offset any adviser charges that are payable (e.g. deferred product charges for an initial period give the impression that no money needs to be paid to the adviser firm);
    - devise a charging structure, disclose it to clients and explain to them any deviation from this structure, for example where they have requested non-standard services. (Firms would still have flexibility about what charging structures to adopt and how to disclose them; for example they could give clients a very detailed price tariff, or alternatively give much broader price ranges and then provide bespoke quotes.) This requirement aims to make sure that: our adviser charging proposals are not undermined by firms putting in place charging structures that perpetuate bias; that adviser charges are clear to clients; and that consumer detriment does not occur as a result of the introduction of adviser charging;

[17] Most providers of retail investment products are not subject to MiFID, but as a minority are – such as some structured product providers – our rules for product providers are included in this notification for the avoidance of doubt. To the extent that MiFID product providers conduct advice business, they will – like any other firms firm – be captured by our requirements with regard to adviser firms.

  - make clear the total adviser charge payable in cash terms; as early as practicable[18];

- where a product provider firm is collecting adviser charges from investments to pass to an adviser firm, it must:

  - validate the instructions it receives to pay adviser charges and offer sufficient flexibility in terms of the adviser charges it facilitates (to ensure that the adviser firm, not the product provider, is determining the charges payable);

  - not pay out adviser charges over a materially different time period, or on a materially different basis of another kind, to that in which it recovers them from the client[19] (and, equivalently, a firm offering a personal recommendation to a retail client must not solicit or accept such payments);

- more generally, product providers must:

  - not advertise on the basis of the adviser charges that an adviser firm could receive, when recommending the firm's products or related services (e.g. not to advertise any 'decency limits' that they operate, beyond which they will require further validation of charges to be paid);

  - make clear the distinction between their product charges and any adviser charges payable, and not defer, discount or rebate their product charges in a way that may appear to offset any adviser charges that are payable (e.g. by charging negative product charges for an initial period, giving the impression that no money needs to be paid to the adviser firm).

37. Where a product provider makes a personal recommendation to a client in relation to a product manufactured or supplied by it (or any of its associates in the same immediate group) it should still be capable of meeting the requirements we have discussed above. In these circumstances, we want to ensure that a vertically integrated firm is not able to appear to provide 'free' advice services, by loading all of its charges into its products. So, we propose that such firms must ensure that their adviser charges are broadly representative of the services associated with adviser services (a "**requirement to ensure there is a level playing field between integrated and non-integrated firms"**).

38. Finally, we propose a requirement to make clear that, where a firm's adviser charges are payable over time, its clients can expect an ongoing service, and the nature of this service and how to cancel it should be made clear[20] (a "**requirement to provide**

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[18] The need for this sort of 'hard' or actual disclosure of payments to advisers is explained in detailed in Section C of our current notification - *Information about the costs of services (hard disclosure of commission and commission equivalent)*

[19] *'Association of British Insurers Research Paper 6: Customer Agreed Remuneration'* by CRA International, January 2008, highlighted the potential for a system of customer agreed remuneration to reduce the potential for provider bias only on the assumption that "provider bias does not re-emerge through competition focusing on factoring rates and decency levels" (available at http://www.abi.org.uk/BookShop/ResearchReports/CRA%20Final%20CAR%20Report.pdf)

[20] In practice, this 'ongoing services' could take a number of different forms – such as the provision of an annual review for a basic portfolio through to much more sophisticated and frequent advice or discretionary management services.

ongoing services in return for ongoing charges”). This reflects not only our desire to ensure that adviser charges are clear to clients, but also our concern that adviser charges are designed in accordance with the best interests of clients and (where received through providers) to enhance the quality of the service to the client. Where no ongoing service is provided to the client in return, it is not at all clear that an ongoing payment to an adviser firm from a client’s investments meets this requirement (although an exception can be made where advice relates to a product that the client will only contribute to over time, as the ability to pay adviser charges over time may allow such clients to afford advice in the first place).

In what way would the amended requirements be additional to those in the Level 2 Directive?

39. The Level 2 provisions under MiFID Article 19 do not deal explicitly with the types of charging structures a firm must offer. However, the requirement for firms to determine their own charges – and associated requirements discussed in this section – could be seen as going beyond MiFID by addressing the way that charges can be set within the scope of Article 26 of the Level 2 Directive.

40. Article 26 requires that fees, commission and non-monetary benefits provided to a firm by third parties do not impair compliance with the firm's duty to act in the best interests of the client. It is our view that current remuneration structures commonly in use in the UK market have grown up in conflict with the ideas behind Article 26, as the ability to set high commissions to be paid to adviser firms is used by product providers as a tool for securing distribution of their products.

41. Arguably, a requirement for adviser firms to determine their own charges (and the associated requirements discussed in this section) could therefore be seen as outside the scope of the Article 4 notification requirement and compatible with measures necessary for the implementation of the Directive. The requirements discussed are also consistent with, and reinforce, the approach outlined in Recital 39 of the Level 2 Directive, that commission payments should only be seen as designed to enhance the quality of the service to the client if the advice is not biased as a result. As noted earlier, we are not seeking to constrain the firms and clients from choosing to have adviser charges paid through deductions from clients’ investments. However, we are including these requirements in our notification on a precautionary basis, in case they are deemed to be within the scope of Article 4.

Specific risks to investor protection not adequately addressed by the Level 2 Directive

42. The risks arising from principal/agent problems in the UK market are great, owing to the significant reliance of retail clients on intermediary firms to make personal recommendations about investments. As it can be difficult to establish whether bias has arisen in personal recommendations made to clients - and the incentives that may lead to commission bias are powerful - implementing the principle in Recital 39 in practice requires specific measures in order to be effective.

43. Our attempts to address the risk of bias through disclosure to consumers have not been effective and our consumer research suggests that disclosure alone is unlikely to be effective in addressing the risk in future. Given this, a requirement on adviser firms to set their own charges (and associated requirements discussed in this section) appear necessary to address the conflict between current remuneration structures in use in the UK market with Article 26 of the Level 2 Directive.

In what way are the risks of particular importance in the circumstances of the market structure in the UK?

44. The significant reliance of retail clients on adviser firms, in regard to personal recommendations about investments, is an important feature of the UK market structure. Within this context, the potential impact of product providers influencing recommendations made, due to their control of intermediary remuneration, is great.

45. While in the past we had hoped to rely upon consumer awareness of the commissions being paid to their advisers to mitigate the risk of remuneration bias affecting recommendations made, our understanding of consumer behaviour and financial capability confirms that UK consumers currently struggle to understand how their adviser is paid. For example, research indicates that many consumers thought that the advice did not cost them anything - reflecting a misunderstanding about how commission payments currently operate and a lack of recognition that the payments could decrease the value of their investment[21]- and that the amount paid as commission would be small, therefore having little impact[22].

46. With consumers shown to be unable to comprehend and make use of information designed to assist them in challenging their advisers about the remuneration paid to them, it is clear that a more direct approach is needed. In order to deliver a successful implementation of the requirement that remuneration paid to a firm giving personal recommendations does not impair compliance with its duty to act in the best interests of the client, we need to constrain the potential for recommendations to be influenced by product providers through remuneration paid to intermediaries.

47. Overall, our amended approach is designed to significantly reduce the potential for product provider bias, and hence enable us to deliver a successful implementation of the Directive. The supporting requirements put forward relating to the practical application of adviser charging reflect the various practices that are of concern (or that could be of concern following the introduction of adviser charging) in the UK market. In order to illustrate some of these concerns, we include the following examples (and while they do not all necessarily relate to MiFID business, the need to avoid creating competitive distortions means that the new requirements would be applied across retail investments products generally):

    - *Widely differential commissions being paid:* The significant differences between typical commissions paid on certain life assurance based investments and potentially competing collective investment schemes mean that the potential for commissions to bias advice is fully evident. For example, when last published in November 2007, the market average adviser commission rate in the UK for a regular premium endowment was more than two-thirds more than for a regular contribution collective investment scheme[23]. With commission rates on competing

[21] *Consumer Research 64: Depolarisation Disclosure*, prepared for the FSA by GfK NOP, February 2008 (available at http://www.fsa.gov.uk/pubs/consumer-research/crpr64.pdf)

[22] *Consumer Research 65a: Services and costs disclosure - Qualitative research with potential and recent purchasers of financial products*, prepared for the FSA by BMRB Social Research, February 2008 (available at http://www.fsa.gov.uk/pubs/consumer-research/crpr65a.pdf)

[23] Market average commission rates were calculated at 40% and 24%, respectively, and published on the FSA's website at the time for firms to use in disclosure documents.

products continuing to diverge, it is apparent that our approach to tackling the significant principal/agent problem in the UK has not been successful, and that the potential for commission to bias advice in the UK remains high.

- *Negative product charges:* In the UK, historically, some costs associated with the sale of life assurance unit-linked products were recovered by the insurer retaining a percentage of the client's investment (with the percentage left to be invested known as the 'allocation rate'). However, a practice has arisen in regard to some insurance-based investments to offer products that invest (or appear to invest) at the start of the product's term, more money than a customer has given the firm, with greater charges imposed later in the life of the product. This reflects the history and structure of the UK life assurance market where, typically, the sales focus is on the initial selling price and takes advantage of consumers' lack of financial capability to see the impact over the life of the policy. Products with negative charges (i.e. greater than 100% initial allocation rates) enable adviser remuneration to be taken without appearing to impact the customer's investment, meaning that product providers may be able to influence adviser recommendations by offering products with higher allocations. We therefore propose to stop providers from offering products with negative charging, to reduce the potential for provider bias.

- *Influence arising from product provider 'decency limits':* In December 2008, we published the results of a thematic review of advice in relation to pension switching. As some insurers already offer flexibility for adviser firms to select their own charges, which are deducted from the client's investment over an agreed timeframe, the review was able to highlight both the potential importance of product providers' controls on the amounts of adviser remuneration that can be taken and the need for product providers to give adviser firms information on the likely effects of the levels and shapes of remuneration chosen on the client's investment yield[24]. The large sums or percentages which some product providers tolerate as deductions mean that we remain concerned that advisers may be incentivised to make recommendations that are not in clients' best interests.

48. We would also support our requirements with supervisory efforts focused on ensuring that firms could not 'work around' the requirements: for example by ensuring that firms do not accept inducements in other forms that are not allowable under the requirements of Article 26 of the Level 2 Directive.

Why is this approach proportionate?

49. Our proposal to make firms set their own charges deliberately leaves firms with choice as to how they structure their fees or commissions – e.g. their charges could be payable in cash or deducted from an investment. At the same time, product providers would continue to be able to offer different prices for their products, allowing competition to operate effectively. In granting such freedoms, we are confident of creating a proportionate approach, to tackle the problem of product provider influence over intermediary recommendations.

50. The viability of this approach is already demonstrated by some firms in the industry, as the past year has seen growing interest amongst firms in business models where

[24] *'Quality of advice on pension switching: A report on the findings of a thematic review'*, FSA, December 2008

advisers determine their own charges, instead of their being set by product providers. In particular, we have seen the growth of 'factory-gate pricing' amongst insurers, where a product provider sets the cost of a product and an intermediary sets a charge for their service separately, but the intermediary's charge can then be deducted from the client's investment over an agreed timeframe[25]. Industry research also suggests that a system where advisers set their own charges is seen by the insurance industry as commercially viable[26].

The rights of investment firms under Article 31 and 32 of Directive 2004/39/EC

51. As with our current notification under Article 4, these requirements would not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive. This is because the FSA will not apply them to firms exercising rights under Article 31 and will only apply them to firms exercising rights under Article 32 in the circumstances contemplated in Article 32(7).

[25] Of the top 20 life assurance firms (based on total UK net premiums, the Association of British Insurers, 2006) approximately 10 operate some form of factory-gate pricing or similar remuneration system.

[26] *Research Paper 6: Customer agreed remuneration - research into the market impact of encouraging customer agreed remuneration*, Report by CRA International for the Association of British Insurers, January 2008 (available at http://www.abi.org.uk/BookShop/ResearchReports/CRA%20Final%20CAR%20Report.pdf)