The FSA's Retail Distribution Review

and its consequences for product providers

February 2012

Glossary of relevant terms

adviser charging

any form of charge payable by or on behalf of a retail client to a firm in relation to the provision of a personal recommendation by the firm in respect of a retail investment product (or any related service provided by the firm) which:

a) is agreed between that firm and the retail client in accordance with the Rules on adviser charging and remuneration (COBS 6.1A); and

b) is not a consultancy charge.

consultancy charge

any charge payable by or on behalf of an employee to a firm or other intermediary (whether or not that intermediary is an employee benefit consultant) in respect of advice given or services provided by the firm or intermediary to the employer or employee in connection with a group personal pension scheme or group stakeholder pension scheme where those charges have been agreed between the firm or intermediary and the employer in accordance with the Rules on consultancy charging and remuneration (in COBS 6.1C).

independent advice

a personal recommendation to a retail client in respect of a retail investment product where the personal recommendation provided meets the requirements of the rule on independent advice (in COBS 6.2A.3R).

personal recommendation

a recommendation that is advice on investments....and is presented as suitable for the person to whom it is made, or is based on a consideration of the circumstances of that person. (A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public.)

restricted advice

a. a personal recommendation to a retail client in respect of a retail investment product which is not independent advice; or

b. basic advice.

retail investment product

a) a life policy; or

b) a unit; or

c) a stakeholder pension scheme (including a group stakeholder pension scheme); or

d) a personal pension scheme (including a group personal pension scheme); or

e) an interest in an investment trust savings scheme; or

f) a security in an investment trust; or

g) any other designated investment which offers exposure to underlying financial assets in a packaged form which modifies that exposure when compared with a direct holding in the financial asset; or

h) a structured capital at risk product

whether or not any of a) - h) are held within an ISA or a HCTF.

The FSA's aims underlying its Retail Distribution Review are laudable. The same underlying concerns have led to a number of initiatives on how to regulate advisers and the distribution of products to retail investors over a long number of years which, to date, have failed to come up with an effective answer to those concerns. It may well be that a drastic solution is required to address the problems.

Most of the FSA current initiatives are due to come in with effect from the end of 2012. These go further than previous initiatives – and are ahead of where the European initiatives currently sit.

The new rules introduce some unwelcome, and perhaps to some extent, unforeseen consequences for product providers. (Indeed some potential consequences for distribution via platforms are as yet unknown because the final provisions for platforms have yet to be determined.) It is these which are addressed in this Briefing Paper.

The FSA's aims

The overall aims of the FSA's proposals are expressed to be:

- improving the clarity with which firms describe their services to consumers;
- addressing the potential for advice and remuneration to distort consumer outcomes; and
- increasing the professional standards of advisers

It is the second of these which leads to particular consequences for product providers.

New adviser charging rules

The FSA want firms to have charging structures that are product neutral, with firms focusing on the level of the service they provide and the outcome for the consumer. Firms should seek to base their charges on the services they provide rather than the type of products they sell. It is for firms to take responsibility for charging structures that they adopt in accordance with this basic principle.

Charges should be in respect of a service – hence the FSA's aversion to continuation of trail commission. There might be ongoing charges where the client is receiving an ongoing service - for example regular reviews of the performance of an investment. The one exception to the ban on trail commission is where the client is buying investments to which they make regular contributions over time.

The new rules are supposed to lead to a shift away from commission payments, which are at the expense of the product provider, to advisers' charges which are expenses to the end consumer. The charging provisions apply to advisers' charges for retail clients investing in retail investment products – note that they need not necessarily have an impact for professional clients who receive advice or for any non-advised sales. The scope of the adviser charging rules excludes recommendations to professional clients and eligible counterparties.

Consequences for product providers

All of this make sense – but there will be substantial consequences for the business models which product providers have traditionally operated.

The FSA's March 2010 Policy Statement 10/6 with final Rules followed through on the proposals for product provider implications of:

- a ban of providers offering commission for advised sales;
- rules for providers willing to facilitate payment of adviser charges through the product, including a requirement to offer sufficient flexibility in terms of the charges they facilitate so that advisers are not constrained in the charges they can make;
- a requirement for providers to validate a client's instructions;
- a requirement for a provider not to pay out or advance adviser charges to an adviser firm over a materially different time period, or on a materially different basis to that in which it recovers the adviser charge from the client (known as "factoring") and
- a ban on an initial allocation rate of over 100% (where a provider offers to allocate more than 100% of a customer's investment) – this last point applies mainly to the life products sector rather than the funds sector.

Issues for UK authorised funds

Focusing on consequences for UK authorised funds:

- **re-thinking the initial charge**

  There has usually been an initial charge levied by the authorised fund manager out of which it has paid advisers' commission. There is likely to be a major change in the way authorised fund managers might decide to levy initial charges.

  Under the new COBS 6.IB.5 wording, from 31st December 2012, except for facilitating payment of adviser charges for a retail client's investments, a product provider must not offer or pay (and must ensure that none of its associates offers or pays) any commissions, remuneration or benefit of any kind to another firm or to any third party for the benefit of that firm in relation to a personal recommendation (or any related services).

  There are transitional provisions for past circumstances – personal recommendations made on or before 30th December; where the offer and payment was permitted by rules in force on 30th December; the contract entitling the right to receive commission remuneration or benefit was entered into before 30th December (which can allow existing trail commission arrangements to run off); and in each case where the retail client enters into the transaction in respect of which the personal recommendation was given within a reasonable time frame of the recommendation being given. These transitional provisions can also transfer to another firm or its associates. It is therefore possible that Managers might wish to consider continuing their current initial charge arrangements in order to deal with the legacy business.

  The COBS 6 Rule will though apply to new arrangements and will mean that the likelihood is that initial charges will reduce for new business.

  The removal of the traditional initial charge approach for new business will introduce transparency such that it will be very clear to direct investors if fund managers decide to maintain an initial charge for direct and non advised sales. Logically the position should be that initial charges reduce across the board and that adviser charging will be separate, distinct - and clearly identified as adviser charging and not as a product provider's initial charge. This of itself could offer a distinct improvement. It will likely though require fund managers to introduce new share classes with different levels of initial charge.

- **facilitating payments of adviser charges**

  The practical route really is that, if one is talking about upfront charges, product providers can arrange for money to be deducted from the total amount received before it is invested so the practical issues really arise for ongoing charges.

  Instead, the focus will be likely given to how the adviser charges might in practice be paid by providers. In practical terms, advisers may well still want to have payment of charges facilitated by fund managers as this will perhaps, from the adviser's viewpoint, be the easiest collection route. From product providers viewpoint however, there will be a new issue to consider so that there can be compliance with the new COBS 6.1B.9 requirement. The FSA have accepted the argument that product providers should not have full responsibility for determining what is an acceptable adviser charge and the Handbook text does indicate that adviser firms need to consider whether a client is likely to be able to benefit from the advice given taking into account the likely adviser charge the client will pay. Providers will though need to obtain and validate instructions from a retail client.

- **ban on factoring**

  Factoring occurs when a product provider pays the adviser the full amount of the adviser charge upfront at a discounted rate and then recovers payment over time through the product. The discount rate and other terms offered could have the potential to bias the recommendation of the adviser firms, hence the ban on factoring. (There is though an option to allow initial advice over time for regular contribution products.)

- **distinguishing types of charges**

  A further challenge will be to distinguish product charges from adviser charges. Provider firms must take reasonable steps to ensure that its retail investment product charges are not structured so that they could mislead or conceal from a retail client the distinction between those charges and any adviser charges payable in respect of its retail investment products. (And they must not include in any marketing materials in respect of retail products or facilities for collecting adviser charges any statement about the appropriateness of levels of adviser charges that a firm could charge in making personal recommendations or providing related services in relation to its retail investment products.) This further emphasises the need to abandon the traditional initial charge approach, whereby the adviser was effectively paid at a rate determined by the provider and which, from the point of view of the investor, would be seen to be levied by the provider.

- **distinguishing types of sales**

  Of course these new rules do not apply to non advised sales. But how should a fund manager deal with a fund which has both advised and non-advised sales otherwise by multiple share class offerings?

- **banning of rebates**

  With the platform model (which has gained real traction) involving rebates to the platforms, a key issue arises with the COBS 6.1.B.5 wording being extended to platforms generally, and whether advised or not advised. It is the position for this ongoing periodic fee which creates particular difficulties for fund managers who must apply the same rate across the board within any particular share class for any particular fund. Certainly though it is not clear – not least because some rebates might not be specifically related to adviser charging. Nonetheless, the FSA appear intent on adding to its rules slightly to make it clear that product providers must not defer discounts or rebate their product charges in such a way that these charges would appear to offset any adviser charges that are payable. This might be an issue which has largely arisen in the context of platforms but it might appear more widely. The FSA's clear intention is to ban payments by product providers to platforms and to ban cash rebates to all consumers – and the FSA has already consulted on a ban on cash rebates to consumers for advised business (draft COBS 6.1A.14A R in Consultation Paper 10/29) which indeed would apply for all products not just products sold to a platform. A Consultation Paper on this topic is expected to be published imminently.

In order to introduce different rates applying to different investors, fund managers need to introduce a number of different share classes with different periodic charges for each. This obviously introduces new administration costs because administrators will have greater work to do in maintaining separate share classes. It also introduces a lack of flexibility because inevitably fund managers will decide on a relatively limited number of share class options which might not suit each and every purpose for each and every platform. With the rebate system there was scope for greater flexibility, and on a case by case basis.

The cumbersome approach of requiring fund managers in effect to set up numerous new share classes appears perhaps to have been underestimated by the FSA. In its Consultation Paper in 2009, the FSA indicated that product providers must offer a sufficient number of options so that advisers and consumers have real choice about the structure and level of adviser charges that can be deducted – offering sufficient flexibility will be important as adviser firms will not generally be allowed to accept and then rebate sums of money from product providers. The FSA, in that same Consultation Paper, estimated the cost of altering systems to charge consumers a factory gate price for products such as introducing additional share classes at one-off costs of £220 million, but this perhaps did not anticipate the ongoing administration charge for those additional individual share classes and the additional complications it will lead to for the literature relating to those additional share classes.

The alternative of cancelling units had its own difficulties because, rather like shares, once issued, units are owned by investors so this option had its legal challenges. Also, even if it were possible, assuming for example that the cancellation of units was authorised by the client, it might have led to tax issues. The new share class route is one which is more practical, if cumbersome and costly.

These changes for charging structures, coming alongside the requirements for UCITS funds to produce new KII documents, give fund managers particular timetabling challenges this year.

It is unfortunate the FSA did not decide to await the outcome of the EU work on PRIPs but that work has been delayed and the FSA clearly take the view that trying to improve the adviser charging position has to be pursued in isolation. One doubts though whether the extent of the consequences were fully anticipated.

Contacts

Kirstene Baillie
Partner
t: +44 (0)207 861 4000
e: kirstene.baillie@ffw.com

The FSA's Retail Distribution Review
and its consequences for product providers

This publication is not a substitute for detailed advice on specific transactions and should not be taken as providing legal advice on any of the topics discussed.

© Copyright Field Fisher Waterhouse LLP 2012. All rights reserved.

Field Fisher Waterhouse LLP is a limited liability partnership registered in England and Wales with registered number OC318472, which is regulated by the Solicitors Regulation Authority. A list of members and their professional qualifications is available for inspection at its registered office, 35 Vine Street London EC3N 2AA. We use the word "partner" to refer to a member of Field Fisher Waterhouse LLP, or an employee or consultant with equivalent standing and qualifications.

Field Fisher Waterhouse

www.ffw.com