Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Dear Tom,

DP 15/3: the FCA's approach to implementing MiFID II conduct of business and organisational requirements

The Financial Services Consumer Panel welcomes this opportunity to provide input into the FCA's implementation process for the second Markets in Financial Instruments Directive. MiFID II will, by and large, benefit consumers and the Panel believes it represents an opportunity for the introduction of reforms in the UK that would be in the best interests of retail investors.

The policy options put forward in the discussion paper will also support the objectives of the European Commission's Capital Markets Union (CMU) initiative, which the Panel has stressed[1] relies to a large extent on increasing trust in the investment industry among retail investors and potential investors.

Given the restrictive transposition timetable imposed by the Directive, it is good that the FCA is taking a pro-active approach to soliciting stakeholder feedback on its discretionary policy options at an early stage.

The issues raised in the discussion paper go to the heart of creating a consistent regulatory framework across all sections of the asset management industry, and a comprehensive approach to implementation of MiFID II could fix many of the problems that give rise to poor consumer outcomes.

We welcome many of the proposals in the discussion paper, including:

- A ban on rebating commission for portfolio management;
- Applying many of MiFID II's provisions to insurance-based investment products (IBIPs) and pensions;
- Extending the MiFID II 'appropriateness' test to insurance-based investment products (IBIPs) and pensions, using the new, stricter, criteria to determine the complexity of a product.

We would also like to the FCA to consider, as part of its implementation process for MiFID II, embodying in regulatory rules and required standards the equivalent of a code of conduct for firms that sell annuities and other pension products on a non-advised basis.[2]

[1] https://www.fs-cp.org.uk/sites/default/files/fscp_response_cmu_may_2015_0.pdf
[2] https://www.fs-cp.org.uk/sites/default/files/annuities_position_paper_20131203.pdf#page=2

We also believe the FCA should be more ambitious on disclosure of costs and charges for IBIPs and pension products.

The Panel's research on investment costs[3] underlined the persistent problems of cost opacity in the asset management industry. The detrimental impact of hidden costs on investment returns, particularly those for pension savers, requires urgent reform. We do not think the FCA should await the outcome of negotiations at European level on cost disclosure that would, in any case, most likely not apply to pension products. We are not aware of any evidence that a delay would benefit consumers, indeed the weight of research points to the opposite conclusion.

We hope you will find our contribution useful, and we look forward to seeing the detailed consultation paper on MiFID II later this year.

Yours sincerely,

Sue Lewis
Chair
Financial Services Consumer Panel

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[3] https://www.fs-cp.org.uk/sites/default/files/investment_discussion_paper_investment_cost_and_charges.pdf

List of questions

Q1: Do you agree that, in principle, we should look to ensure a consistent regulatory regime between insurance-based investment and pension products, and MiFID II investments? If not, please explain why.

Yes. The Panel supports the FCA's aim of adopting a coherent and consistent approach to the regulation of MiFID II-covered products on the one hand, and IBIPs & pensions on the other. As noted in the discussion paper, insurance-based investment products and most pension products are already within the scope of the Retail Distribution Review (RDR) and it makes sense to maintain this consistency.

The Panel believes that the recast Insurance Mediation Directive (the Insurance Distribution Directive or IDD) should be aligned with MiFID II as much as possible. It took position on this firmly in its recent position paper on the IDD[4], and continues to raise this issue with stakeholders in the European Parliament as negotiations on the final legal text progress.

Full alignment would avoid regulatory arbitrage, preventing firms from purposefully (re-)designing investment products to meet the least stringent requirements under either MiFID II or the IDD. It would also create a consistent approach that enables firms to adopt one set of policies to conform to regulatory requirements.

However, we consider it doubtful that the IDD will include pension products in its scope as both the European Parliament and the Council of the EU excluded these products from the Directive in their negotiating positions[5][6]. Moreover, even full alignment between MiFID II and the IDD provisions on IBIPs may not be achieved as we understand this is not being treated as a priority during the trilogues.

In this context, the Panel would welcome a decision by the FCA to use its discretion to read across MiFID II rules to IBIPs and pension products. For the latter in particular, no overarching European framework may exist for the foreseeable future, making it even more important for the FCA to take the initiative at domestic level to close what would otherwise be a substantial regulatory loophole.

Disclosure of costs and charges

We do not agree with the FCA's assessment that it should wait before considering applying MiFID II's cost disclosure requirements to IBIPs and pension products.

There appears to be an inconsistency in the discussion paper's approach to the potential outcome of the IDD negotiation process as regards costs disclosure, and other elements of the new Directive that are applicable to IBIPs. For example, the 'appropriateness' test for non-advised sales of complex investment products is a candidate for being applied to IBIPs even if the new IDD were not to make this a legal requirement. It is unclear to the Panel why a similar approach could not be taken to comprehensive cost disclosure for IBIPs.

Moreover, the Panel does not believe that the reasons given in the discussion paper on new cost disclosure requirements are relevant for the provision of pension products in particular. The paper cites the negotiations on the IDD, the new 'Key Information

[4] https://www.fs-cp.org.uk/sites/default/files/fscp_position_paper_on_imd1_20150120.pdf
[5] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fTEXT%2bTA%2bP7-TA-2014-0155%2b0%2bDOC%2bXML%2bV0%2f%2fEN&language=EN, article 2(1)(4)(c)-(e)
[6] http://data.consilium.europa.eu/doc/document/ST-14791-2014-REV-1/en/pdf , article 2(4)(c)-(e)

Document' under the PRIIPs Regulation[7] and the recent joint FCA/DWP work on reporting transaction costs in workplace pension schemes.

In this context, the Panel would repeat that it appears unlikely, at this stage, that the IDD will include pension products in its scope. Both the European Parliament and the Council of the EU excluded these products from the Directive in their negotiating positions, making it unlikely that they will be brought into scope during trilogues.

Similarly, the PRIIPs Regulation expressly provides in its recital 7 that 'individual and occupational pension products, recognised under national law as having the primary purpose of providing the investor with an income in retirement' are excluded from the scope of the Regulation.

The Panel has responded to the recent FCA/DWP consultation on reporting transaction costs in workplace pension schemes. We understand this work must be concluded soon as the legislation that requires IGCs and Trustee Boards to assess schemes' value for money is now in place. The Panel believes that any work relating to cost transparency on both pensions and non-pension products must be consistent; therefore it makes sense for the FCA to work with the joint DWP/FCA team to ensure consistency in this area across all products.

Given the well-documented nature of the problem and the significant impact cost opacity continues to have on consumers' ability, and that of their advisers, to assess value for money, we would urge the FCA to reconsider its decision not to extend the new comprehensive cost disclosure requirements to insurance-based investment products and pensions as part of its work on the implementation of MiFID II.

Q2: Assuming IDD does not replicate MiFID II in terms of changes to suitability assessments and client reporting, we plan to apply minor changes where we currently read-across MiFID II rules to insurance-based investments and pensions. Do you agree with this approach? If not, please explain why not.

Yes. This would preserve the consistency and coherence of the regulatory framework across a market in which the different types of products are largely substitutable.

Q3: Assuming IDD does not replicate MiFID II in terms of the appropriateness test, should we look to apply MiFID II's appropriateness test to sales of insurance-based investments and pensions?

Yes. The Panel would support extension of the 'appropriateness' test for non-advised sales to IBIPs and to pension products in particular.

We have repeatedly stressed the evidence of a shift towards purchasing annuities via 'non-advised' sales. With the recent pension reforms, this practice has started to extend to more complex products such as drawdown.

Research published by the Consumer Panel in 2013 suggested that the increase in non-advised sales appeared to be driven by lighter touch regulation and higher profit margins, not consumer demand.[8]

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[7] Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014

[8] https://www.fs-cp.org.uk/sites/default/files/research_into_purchasing_annuities_interviews_with_experts_final_report_20131029.pdf

Non-advised sales often have opaque costs and give greatly reduced consumer protection if things go wrong. The applicability of the 'appropriateness' test would put a greater responsibility on firms to ensure the customer understands the product and the associated risks.

However, the Panel would like the FCA to go further than simply extending the appropriateness test. Consumers do not understand the difference between advised and non-advised sales, and at the very least must be alerted to the loss of protection if they go the non-advised route. The risk of consumer detriment is real and immediate.

The Panel calls again on the FCA to embody in its rules and mandatory standards the equivalent of a code of conduct for the non-advice market.[9] This would include mandatory standards which guarantee high professional standards, the transparent disclosure of charges, and a clear explanation of the implications of non-advice for consumer protection.

Q4: If we were to apply MiFID II's appropriateness test to insurance-based investments, what factors or criteria do you consider make an insurance-based investment and pension product complex?

Whether a product should be considered complex is heavily dependent on the financial capability of the individual retail investor.

The determination of whether a product is 'complex' should therefore be made on a case-by-case basis, and be based primarily on the knowledge and background of each specific customer, rather than a set of pre-defined product features considered to be complex. This requires a principles-based approach that can be deployed flexibly and fairly, instead of an approach that relies on a list of concrete characteristics of a product, as these may become outdated or offer 'safe harbour' opportunities for firms.

In this respect, it may be helpful for the FCA to follow the definition proposed by IOSCO[10], which defined a "complex financial product" as a "financial product whose terms are not likely to be understood by an average retail investor, where the product has a complex structure, is difficult to value without specific skills/systems and/or has a very limited or no secondary market and is therefore potentially illiquid".

Q5: Assuming IDD does not replicate MiFID II with regard to product governance and staff remuneration provisions, to what extent should we look to apply MiFID II's obligations to insurance-based investments and pensions? What would be the implications of doing this, or of not doing it?

For reasons of consistency, the Panel supports extending the MiFID II requirements on product governance and staff remuneration to IBIPs and pensions. For legal clarity we would want the recast Insurance Mediation Directive to be aligned with MiFID II, but should this not be the case we believe the FCA should extend the MiFID II requirements unilaterally.

There is a clear need for better product oversight and governance of IBIPs and pensions, and the rationale for the inclusion of these obligations in MiFID II applies equally to these types of products. This is particularly true of the new types of retirement or investment products that may emerge in the UK market following the April 2015 'pension liberalisation' reforms. It will be relatively easy for firms to design retirement products

[9] https://www.fs-cp.org.uk/sites/default/files/annuities_position_paper_20131203.pdf#page=2
[10] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf#page=8

that fall outside the scope of MiFID II. A lack of rigorous product governance would compound the risks to consumers of a complex and rapidly evolving market.

The FCA's proposed read-across of its rules to other investment and pension products would at least ensure that a consistent regulatory regime applies, with an obligation on firms to act with their customers' best interest at heart.

Any costs to the industry of ending inappropriate incentive structures, as well as ensuring products are well-designed and targeted at the appropriate markets, are more than outweighed by potential reductions in mis-selling and the concomitant increase in consumer trust in the industry. In parallel, this would also see firms face fewer fines for misconduct.

Q6: What should our approach be to incorporating the new requirements for structured deposits into our conduct of business rules?

No comment

Q7: Should we develop rules to ban rebating of third party payments altogether by DIM firms to clients?

Yes. The Panel has previous said that 'rebating commission to customers is an unacceptable compromise,' and this remains our position.[11]

The ability to rebate commissions does not prevent commission bias, and results in advisers seeking the highest commissions and promoting the rebates as a marketing tool. Therefore it does not ensure advisers are the true agents of their customers.

In addition, to tackle product-type bias, there would need to be a requirement to prevent advisers being allowed to charge more for recommending one particular type of product than for recommending a comparable product, and this has not been provided for in the Directive.

The practice of rebating increases complexity and cost opacity, making it harder for consumers to work out whether they are getting a good deal and compare products - they will still be in the dark about the true cost of advice.

The Panel would therefore encourage the FCA to ban rebating of third-party payments to clients by DIM firms altogether.

Q8: Should we develop rules to ban cash rebating of third party payments by DIM firms to clients, but allow other types of rebating?

No. The Panel supports the introduction of rules by the FCA that would ban rebating of third-party payments by DIM firms to clients altogether.

Q9: Do you agree with our approach to re-categorise local authorities undertaking non-MiFID business as retail clients, with the option to opt up to elective professional client status? Do you agree that that the opt-up criteria for local authorities should follow our existing approach with respect to non-MiFID business?

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[11] https://www.fs-cp.org.uk/sites/default/files/cp-letter-to-meps-mifid-commission20120925.pdf

No comment

Q10: Do you agree with the approach set out in option A and the possibility of providing guidance on the qualitative test? If so, please explain what sort of guidance you think would be useful. Please provide any evidence to support your views.

No comment

Q11: Do you agree with the approach set out in option B? Please provide your comments and any evidence to support your views.

No comment

Q12: Do you agree with the approach set out in option C? Please provide your comments and any evidence to support your views.

No comment

Q13: Do you consider that MiFID II's standard of independent advice is different, in practice, to the UK's RDR standard? If so, please explain why.

Yes. The Panel's understanding of why some firms have chosen to move from 'independent' to 'restricted' status in the UK is that they do not want their advisers recommending high-risk or niche investment products, and they are therefore excluding some types of investment product from their product offering. However, under RDR rules, the definition of 'independence' requires firms to consider all types of retail investment products which are capable of meeting the investment needs and objectives of a retail client.

Although the FCA has not found widespread misuse of the term 'independent', many firms felt they could not continue to use this definition because of the restriction in product offering. This has caused some firms offering a whole of market service within a limited product range to err on the side of caution and move to 'restricted' status. This causes confusion for consumers who are constantly urged to choose only 'independent' financial advisers, when in reality many restricted advisers are offering a similar service often at a price more in line with middle market budgets.

The Panel believes the MIFID II definition of 'independence', which says that advisers must consider a 'sufficient range' of products, is more realistic for the majority of consumers in the retail investment market. This is more in line with the pre-RDR definition of independence.

The MIFID II definition still requires firms offering independent advice to cover all relevant product providers, but does allow a firm to exclude some products from its product range. The Panel believes that many of the firms currently operating under 'restricted' status could revert to independent status under MIFID II, which would alleviate much of the confusion over the 'independent' and 'restricted' labels and widen access to regulated financial advice.

Those firms that are restricted in the number of providers they recommend would not be able to call themselves independent.

Q14: How should we implement MiFID II's requirement to develop an independence standard for advice on shares, bonds and derivatives?

No comment

Q15: Should we continue to include insurance-based investments and pensions within our definition of 'retail investment product'?

Yes. We agree that insurance-based investments and pensions are in the same relevant market as MiFID II investment products, and like the FCA, do not believe that a separate regulatory framework for advice on these products would benefit UK consumers.

Any measures which would in effect introduce a parallel regime for IBIPs and pensions would likely encourage firms to exploit possibilities of regulatory arbitrage, thereby distorting competition and reducing consumer protection overall.

Q16: Should we include structured deposits within our definition of 'retail investment product'?

Yes.

Q17: Do you think we should explore applying MiFID II's remuneration standards for sales staff and advisers across to non-MiFID business?

This would be desirable, but it is not clear to us that it fits easily with MiFID II transposition, which has strict legal deadlines.

Moreover, given the recent establishment of the new Remuneration Regime for the banking industry and the existence of other applicable rules, we agree it would be legally and technically complex. We conclude that a single, cross-cutting remuneration regime is a desirable long-term aim, but needs more time and thought.

Q18: Do you agree that Article 3 firms should be subject to a regime that is identical to the regime for non-Article 3 firms? What impact would this have for these firms?

No comment

Q19: What other approaches do you suggest we could take that would meet the objectives of the MiFID II requirement?

No comment

Q20: Do you agree that the two recording exemptions for discretionary investment managers should be removed?

No comment

Q21: Do you agree that discretionary investment managers should be required to comply with Article 16(7) of MiFID II?

No comment

Q22: Are there any technical challenges firms are likely to face in meeting these disclosure requirements that you feel we might be able to help address? If so, what solutions do you suggest to overcome these challenges?

Although the Panel's research[12] found that investors – both retail and institutional – are often unaware of the total costs of investing, this is not because it is impossible for the investment firm to provide a comprehensive and accurate overview of all charges.

Knowledge of different types of costs is frequently dispersed throughout an asset management firm. Sometimes they are hidden because they are deducted from the invested funds, rather than charged to the customer directly.

The Panel has therefore strongly recommended that retail fund structures should be simplified to make greater transparency easier to achieve. We believe the FCA should consider a ban on investment managers attributing costs and charges to the fund. Instead, the investment manager should levy a single charge to reflect all the costs of running the fund. As well as increasing transparency and comparability, a single charge would make it significantly easier for firms to meet their MiFID II disclosure requirements.

Some in the asset management sector have argued full disclosure of costs is too technically complex, but we would note that such dissent is not universal. We believe that the FCA should explore this issue in its forthcoming asset management market study.

Q23: Should we investigate developing a standardised format for disclosing costs and charges for both point-of-sale and post-sale disclosures?

The Panel has no particular position on further FCA work in this area, but we suggest the FCA should draw on the outcomes of the consumer research being undertaken as part of the implementation of the PRIIPs Regulation.

Q24: Do you agree that we should maintain domestic consistency and look to apply MiFID II's inducement standards for independent advice also to restricted advice?

Yes. Applying the MiFID II rules to restricted advice would maintain the consistency of the current approach and remove an incentive on firms to offer restricted rather than independent advice to take advantage of laxer rules on inducements.

Q25: Do you agree that we should continue to have a consistent inducements regime for sales of MiFID II products and insurance-based investments and pensions? If not, please explain why.

Yes. Any reduction in the use of inducements is welcome, as they often act to incentivise staff to sell products inappropriately without regard to the customer's best interest.

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[12] https://www.fs-cp.org.uk/sites/default/files/investment_report_executive_summary_for_the_fscp.pdf

Moreover, a consistent approach would negate any potential exploitation of regulatory arbitrage which would allow inducements to be paid for some types of investment products but not others.

In view of the emergence of new, potentially toxic, IBIPs and pension products following 'pension liberalisation', it remains important that firms are not incentivised to sell inappropriate long-term products to their customers.