Financial Conduct Authority

Guidance consultation

Changing customers to post-RDR unit classes

October 2013

Introduction

This guidance sets out what we expect from firms which are involved in the transfer of investors from pre-RDR unit classes[1] to post-RDR unit classes.

We are setting out our approach as a result of a number of queries from stakeholders and some evidence of uncertainty in the procedure to adopt when converting customers to the new unit classes.

Background

The implementation of the Retail Distribution Review (RDR) rules on adviser charging[2] has resulted in the introduction of new unit classes (widely referred to within the industry as 'clean' unit classes) within collective investment schemes. These post-RDR 'clean' classes bear a lower annual management charge, excluding the portion of the charge that was formerly rebated to advisers, in line with the RDR ban on commission payments.

In the case of platforms, Policy Statement 13/1[3] referred to the introduction of clean unit classes and announced the banning of payments to platforms from product providers. These particular rules will come into force on 6 April 2014, with the rules in relation to legacy payments to come

[1] The term 'unit class' is used throughout this document. References to 'unit' within the FCA Handbook apply to both units in an AUT and shares in an ICVC. This document shares that referencing, so references to 'unit class' also include 'share class' in respect of an ICVC.
[2] PS10/6: *Distribution of retail investments: Delivering the RDR - feedback to CP09/18 and final rules*: http://www.fca.org.uk/static/documents/policy-statements/fsa-ps10-06.pdf (March 2010)
[3] PS13/1: *Payments to platform service providers and cash rebates from providers to consumers*: http://www.fca.org.uk/static/documents/policy-statements/ps13-1.pdf (April 2013)

into force on 6 April 2016. Despite the extended two-year period, we expect to see a significant move into clean unit classes well before this date, due to the lower charges and the operational issues of stopping the payment of rebates to advisers (when existing contractual arrangements are in place).

We have found from recent discussions that there is some uncertainty over whether a conversion to a clean unit class should be treated in the same way as a switch involving cancellation of the existing units and issue of new units. Questions have also arisen about:

- whether conversions can happen in bulk rather than individually
- if conversions can happen without express consent of the client
- whether advice is needed
- the role of advisers in the conversion process, and
- whether a new disclosure document (e.g. a Key Investor Information Document (KIID) for a UCITS scheme) needs to be issued to the customer before conversion

This guidance answers these questions.

'Converting' instead of 'switching' unit classes

It is our understanding that in most cases the move to clean unit classes will be accomplished by converting units (replacing one unit with another of a different unit class) rather than switching (which involves cancelling one unit and issuing another). The holder of the units has a right to convert from one class to another, as established in COLL 6.4.8R.

Conversion procedures for nominee arrangements

We would expect any authorised fund manager (AFM) or other firm (e.g. platforms or nominees) undertaking the conversion of units to clean unit classes (and any firms providing advice to clients regarding conversions) to consider a number of points before proceeding.

COBS 2.1.1R (1) (the 'clients best interests rule') in the FCA Handbook states:

'A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule).'

It is our view that under this provision and Principle 6 of the Principles for Business, a conversion should take place only if it is fair and in the client's best interests. We would expect in most cases that the clean unit class would be exactly the same as the pre-RDR class, with the only difference being the reduced annual management charge. However, if this is not the case, and if a client is in any way disadvantaged by such a conversion, we would not expect that conversion to take place – so we would expect the effect of the conversion on clients to be considered.

In the particular case of nominee arrangements, we have received a number of questions from firms who hold units on behalf of beneficial owners[4], about whether they can simply ask the AFM to convert the units they hold to clean classes without having to seek the consent of the beneficial owner.

[4] These firms are defined as 'intermediate unitholders' in the FCA Handbook: http://fshandbook.info/FS/glossary-html/handbook/Glossary/I?definition=G2891.

The definition of 'unitholder' in our Handbook[5] refers to 'the person whose name is entered on the register (of unitholders)'. As a nominee is the registered holder of the actual units, the COLL rules do permit the nominee to exercise any right to convert from one class to another, provided that doing so does not contravene any provision in the prospectus of the fund (as per COLL 6.4.8R).

We also expect nominees to ensure the client is given prior notification that the conversion will take place and is given the option to object. For example, the notification could state that the conversion will take place unless an objection is raised within a reasonable specified timeframe. Such a notification should be made in a manner appropriate to the nominee's ongoing dealings with the client (for example, if a nominee deals with the client primarily by electronic communication, such as email, the notification should be made by this method).

Nominees should bear in mind any notification, disclosure or other contractual requirements that may exist in their contractual relationship with the client or the client's chosen financial adviser, concerning the nominee arrangements. This guidance contains our position on conversions, but firms should also bear in mind that the conversion will also be subject to any contractual arrangements firms have agreed with the underlying investor.

While the ban on rebates in the platforms market does not apply to non-platform adjacent markets (such as SIPP operators), PS13/1 noted our intention to consult on rules covering these firms at a later date where necessary. Given the publically-stated intention of a number of providers and platform operators to move to clean unit classes as soon as possible, we consider it important for this guidance to be issued before any such consultation. We may wish to provide further comment on this matter at a later point once this consultation has taken place.

Conversion procedures for direct unitholders

The rules in COLL do not permit the AFM or firms who are not unitholders to convert clients to clean unit classes without their express permission, as without a nominee arrangement the client will be the unitholder, so the client will be the person who has the right to convert under COLL 6.4.8R. In this situation, the client must make the request to convert to a clean unit class, or at least provide their explicit consent for the conversion.

Firms can simply notify clients of the existence of clean unit classes, and leave it up to the client to make the request to convert. Alternatively, firms may wish to highlight the benefits of conversion to the client or recommend they seek advice.

Advice on conversions

Some questions have focused on whether a conversion would constitute advice. For nominees, a notification that a clean unit class exists to which it is proposed to convert all existing client's holdings, explaining (where this is the case) why it is in the client's best interests, does not constitute advice. The actual conversion itself is also not 'an advice event' as this will be an action that follows on from obtaining the client's consent. If the client is given such a notification, they then have the option to seek advice on the matter.

However, as mentioned above, unless a nominee arrangement is present, the client must make the request to convert. Again, a notification that a clean unit class exists (without a specific

[5] http://fshandbook.info/FS/glossary-html/handbook/Glossary/U?definition=G1233.

recommendation to convert to that class) does not constitute advice. A recommendation to a direct unitholder to convert to the clean unit class, however, will constitute advice on investments.

Advisers and their role in the conversion process

If the client is investing in a fund as a result of the recommendation of a financial adviser and that relationship still exists, then that adviser may have a role to play in the conversion process. While legacy payments to platform providers will come to an end in April 2016, advisers may wish to consider contacting platforms and product providers before this date to discuss the appropriate timing of conversions to clean unit classes for their clients.

Equally, we would encourage platforms and product providers to also engage with a client's financial advisers in good time when considering converting investors holdings to clean unit classes, so the financial adviser has an opportunity to discuss the conversion with their client as appropriate.

Providing a Key Investor Information Document (KIID) when converting to clean unit classes

There have also been some questions about whether a conversion from a pre-RDR unit class to a clean unit class requires a new KIID to be provided to the client for the new unit class under COBS 14.2.1R (7).

The move to clean unit classes will be accomplished by conversions rather than switching units. We consider that a new KIID would not need to be provided upon conversion, as long as:

- The firm has assessed that the conversion is in line with the client's best interests rule and Principle 6 of the Principles for Business (as outlined above).
- The clean post-RDR unit class is identical in all respects to the former class in which the client was invested, save for the reduced annual management charge.
- Clients that are being pro-actively converted are given prior notification that the conversion will take place and are given the option to object (as outlined above).
- Clients are given the option to request the KIID for the clean unit class or advised how they can access the document electronically.

How to respond to the consultation

We are asking for your written response to this consultation by 23 November 2013. We cannot guarantee that we will consider responses received after this date.

You can send your response by email to Stefanie.Thorns@fca.org.uk, or by post to Asset Management & Funds Team, Policy Risk & Research Division, Financial Conduct Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS. There is no need to submit a response by post if you are also emailing it.

When responding, please state whether you are doing so as an individual or on behalf of an organisation. Please include your contact details with your response, in case we need any more detail on any issues you raise.

Annex: Cost benefit analysis

1. This guidance is expected to result in some costs for nominee firms who wish to pro-actively convert clients, as we confirm that conversions to clean unit classes require sending a prior notification to the client. However, we do state that this notification can come via electronic communication such as email, if this method is suitable to the manner in which the firm conducts its other business with the client.

2. The industry as a whole should benefit from this guidance, as it provides a clear process for the industry to follow, ensuring that all firms affected by the introduction of clean unit classes follow the same procedures.

3. This guidance is intended to benefit all clients, including those who choose to invest via nominees, by ensuring that they are kept adequately informed during the conversion process. By issuing this guidance, we hope to ensure that clients who are either pro-actively converted or who request a conversion, benefit from a smooth and uniform process.