FCA
Smaller Business
Practitioner Panel

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26th May 2015

Dear Tom,

DP15/3: Developing our approach to implementing MiFID II conduct of business and organisational requirements

This is the FCA Smaller Business Practitioner Panel's response to your Discussion Paper on implementing MiFID requirements. The Panel is a statutory body created at the same time as the FCA. Its key remit is to provide input from the industry in order to help the FCA in meeting its statutory and operational objectives from a smaller business standpoint, and it is from this particular standpoint that we have written our response.

General comments

One of the Panel's key themes is that of proportionality. We appreciate that the MiFID rules did not originate with the FCA, but we urge you to be aware of resource constraints applying in particular to smaller firms. Smaller firms will have much less in the way of dedicated resource in dealing with fundamental rule changes such as MiFID. We would also like to point out, for example, that there is currently a great deal of pressure on smaller software providers to make regulatory changes to firms' systems. This means there is no spare capacity for firms to be able to implement more innovative software which is proving a barrier to innovation in both products and services.

Chapter 2 Applying MiFID II rules to insurance based investment products and pensions

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, why not?

In principle we agree that wherever possible high level conduct of business rules should apply to insurance based investments and pension products. This should aim to create a regulatory regime that maintains a consistent level of protection for clients whilst reducing the complexity of providing different information for different versions of products that are for all intents and purposes identical.

However insurance products have different market structures and product characteristics that, in our opinion, make it more appropriate for more detailed requirements to be set out in the Insurance Mediation Directive (IMD 2) and Insurance Distribution Directive (IDD) rather than in MiFID II. Otherwise the FCA could duplicate IMD2/IDD and there is a risk insurers could be subject to parallel and potentially conflicting regimes.

Therefore while we support the high level principles of MiFID II being extended to insurance investment products and pensions, it is our view that the FCA should wait for the more detailed IMD2/IDD requirements to be finalised.

We would be concerned if, as a result of these changes, there were any impact on how the FSCS levies are charged on advisers.

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.

This seems like a practical approach. In practice we do not believe that advisers will find a fundamental difference in how they advise on these products to their clients. However, for the same reasons as given in the answer to Question 1, we feel that the FCA should not make any decision until an agreement under IMD 2/IDD is reached. Clarity on what is covered by MiFID and what is not would be helpful.

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?

In theory we are supportive of this approach, and believe it could be beneficial both for the consumer whilst adequately protecting the adviser. But again, we would strongly urge the FCA to hold back from making decisions prior to an agreement under IMD 2/IDD.

Alongside the ABI we would suggest considering the application of the appropriateness test to pensions when they come under the scope of PRIIPs.

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 investments and pension based product complex?

The issue at hand is the complexity of the investment funds, not the wrappers themselves. Applying a strict reading of MIFID 2 the regulations on complexity would not necessarily apply to pension products if the underlying investments were non-complex.

This could lead to the situation where a clearly complex pension product could be defined as non complex as a result of the investment options. For example assuming the exclusive availability of non complex investment options a pension product would be defined as non-complex even where there could be a loss in safeguarded benefits, where there could be tax implications, or where there are overseas products such as QROPS involved.

Similarly an annuity could be considered non-complex if there are complications with impaired life/ill health annuities versus standard annuities provided no complex investment options were provided.

This underlines the need to define complexity (or non complexity) as a research driven obligation on providers rather than an investment only blanket categorisation which will only lead to customer confusion.

Article 25(4) of MiFID II suggests that any investment product which embeds a derivative would fall outside of the scope of a non-complex product. This may be in danger of ruling out straightforward FTSE-All Share tracker funds which may exploit derivatives as part of efficient portfolio management. Therefore, we would strongly urge the FCA to consider that the use of derivatives (or derivative like investments) within an insurance product does not automatically define them as complex.

Similarly, insurance product links to investments such as a with profits fund, which can have derivative like qualities whilst not actually employing them, may be caught by a strict application of MiFID II without careful wording of the definition of complex and non-complex.

Our concern is that without prudent application of the rules, with profits investments may be caught by this change meaning that direct clients could be sold a tracker or mixed asset managed fund without any appropriateness test, but a with profits fund designed with guarantees and reduced volatility could not. This would mean clients are deprived of the very sort of fund designed to enable them to reduce risk through pooling and sharing which is not, we believe to be, the intention of the directive.

We would therefore suggest that the factors that define a complex product should clearly focus on whether the risks and potential rewards of an investment fund are difficult for a consumer to understand. In our view, establishing whether a product is difficult to understand should be firmly based on pre and post sales consumer research. This should place an obligation on the provider to demonstrate that clients not only understand the risks associated with an insurance based investment but also the potential for reward. Similarly, the product provider should, through research, be able to demonstrate that clients can understand and explain the fluctuating value of an investment over time as well as the value and application of any guarantees.

Q5. Assuming the 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? What would be the implications of doing this or of not doing it?

Our view is that the important point here is consistency, and that remuneration provisions in relation to insurance based investments should be consistent with pensions. The result of this would be to help reduce product biases. However we would expect the provisions to be proportionate to the risks being taken, level of complexity of the products and the nature of their distribution. It is difficult to judge the impact, but it is likely to impact most heavily on firms where registered individuals have moved from financial advice to insurance products as a result of the RDR. Conversely this would represent a professionalization/improvement in standards for non-RDR firms.

Chapter 3 – Treatment of structured deposits

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

We support the third approach, in paragraph 3.11, of fully incorporating deposit structured products into COBS. This should result in more consistency and simplicity, and on a practical level many firms already apply the COBS standards to advice on these types of products anyway. One point we would highlight is the possibility of a provider of these products becoming insolvent. We would like clarity on whether the FSCS levy in this situation would be placed upon the adviser community, which we consider would be unfair.

Chapter 4 – Receipt of commissions and other benefits for discretionary investment managers

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

Yes. We believe that banning third party payments by DIMs to clients would provide consistency with the current RDR rules.

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

We believe that allowing other types of rebating to take place could lead to confusion and misinterpretation, and therefore do not support this approach. All rebates should be banned.

Chapter 6 – Adviser Independence

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.

We believe there are potential problems with the wording 'a sufficient range of products from a sufficiently diverse group of providers' lacks clarity and could lead to problems. The RDR definition 'comprehensive and fair analysis of potential products in a relevant market' is in reasonable agreement with the MiFID II definition as long as the FCA does not retrench to 'whole of market'.

We would encourage the FCA to use examples of good and poor practice in defining an independent adviser. The Panel has already provided input to the FCA's work on adviser disclosure. We believe that where possible it is better to explain an adviser's work in terms of what they do, rather than what they do not. We look forward to seeing the FCA's thoughts in its further work on smarter consumer communications.

We have concerns that implementing the MiFID II definition will be resource intensive, particularly for smaller firms, without a clear benefit for UK consumers. It is arguably geared towards markets that still rely on commission and single ties (eg the reference to 'a sufficient range of different product providers' products').

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

Section 6.21 (a sensible 'basket' approach of products in relation to shares and bonds) seems to be consistent with the RDR.

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

Yes. Insurance-based investments and pensions should continue to fall under the definition of retail investment products. We believe this approach would aid consistency and reduce potential confusion.

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

Structured deposits should fall under the definition of retail investment products to avoid potential regulatory arbitrage in product design.

Chapter 7 – Applying MiFID II's remuneration requirements for sales staff and advisers to non-MiFID firms

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

Yes. We strongly agree, particularly where business might be done outside MiFID but under PRIIPs. However there are remuneration provisions currently in place or coming into force for insurers (Solvency II). Therefore it is important with the read across that the FCA avoids conflicting remuneration regimes and the guidance remains high level.

Chapter 8 - Recording of telephone conversations and electronic communications

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?

In practice, this will mean having all telephone conversations recorded. This is an example of the point raised in our general comments where we believe this would have a disproportionate effect on smaller firms at a time when there will be an increase in capital adequacy requirements and increasing PI costs. Such cost increases could be the final straw in driving the smallest firms out of business, especially if higher regulatory capital requirements were to be imposed as well.

Financial Adviser firms are not order takers and those firms such as stock brokers which do conduct the reception, transmission and execution of client orders should already have the relevant permissions in place.

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

We believe that requiring signed minutes of client meetings and for the client to sign the suitability report confirming the instructions would meet the MiFID requirements.

Chapter 9 – Costs and charges disclosures

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?

We believe the FCA should take a pragmatic view on implementation. Smaller firms may struggle to provide information within short timescales. A flexible approach to implementation for smaller firms would be helpful.

On specific issues, we support the principle of providing aggregated costs to improve transparency for investors, however we feel that disclosure should focus on the costs known in advance. There are problems with trying to provide clients with certain costs up front - for example they are likely to be variable and may change following pre-sale disclosure of the costs.

There is also the additional challenge that the UCITs KID currently does not require the same level of disclosure as the PRIIPs KID and MiFID II. Therefore the PRIIPs KID will disclose more information than the UCITs KIID. We strongly believe that the PRIIPs KID and the UCITs KIID should be aligned as closely as possible.

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

Yes. This is an area where the Panel has supported the FCA's work. We believe standardised disclosure, in a format that is easy for customers to understand, is a powerful tool in helping consumer understanding. We have encouraged the FCA to look at other industries (such as the US motor industry 'Monroney sticker') to identify best practice. However, we believe the FCA should use consumer testing to show that the chosen format would provide a meaningful comparison between different products.

Chapter 10 - MiFID II's revised inducements standards

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.

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?

Yes.

Yours sincerely,

Clinton Askew
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