Financial Conduct Authority

Developing our approach to implementing MiFID II conduct of business and organisational requirements

March 2015

Discussion Paper

DP15/3

Contents

We are asking for comments on this Discussion Paper by 26 May 2015.

You can send them to us using the form on our website at:
www.fca.org.uk/your-fca/documents/discussion-papers/dp15-03-response-form.

Or in writing to:

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Abbreviations used in this paper

AIFMD	Alternative Investment Fund Managers Directive
BCOBS	Banking Conduct of Business sourcebook
BIPRU	Prudential sourcebook for Banks, Building Societies and Investment Firms
COBS	Conduct of Business sourcebook
CRD III	Capital Requirements Directive III
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
DWP	Department for Work and Pensions
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ESMA	European Securities and Markets Authority
IDD	Insurance Distribution Directive (formerly 'IMD II')
IMD	Insurance Mediation Directive
KID	Key Information Document
MCD	Mortgage Credit Directive
MiFID II	Recast Markets in Financial Instruments Directive
MiFID I	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
PRIIPs	Packaged Retail and Insurance-based Investment Products
RDR	Retail Distribution Review
SYSC	Senior Management Arrangements, Systems and Controls sourcebook
UCITS	Undertakings for Collective Investment in Transferable Securities

1. Overview

Introduction

1.1 The Markets in Financial Instruments Directive (MiFID I) is a central piece of EU legislation for the regulation of financial markets and has been applicable in the EU since November 2007. It regulates, inter alia, the authorisation and the supervision of investment firms, the requirements for the provision of investment services and activities, the authorisation and supervision of trading venues and the requirements for trading activities of financial instruments across the EU. National authorities can only add additional regulatory requirements to those in MiFID I in limited circumstances.

1.2 In response to the financial crisis and to strengthen investor protection and financial market transparency, MiFID I has been reviewed and revised (with part of the revisions being included in the Markets in Financial Instruments Regulation (MiFIR)). The MiFID II/MiFIR rules are aimed at promoting the integration, competitiveness, and efficiency of EU financial markets. MiFID II/MiFIR introduces changes that will have a large impact on the EU's financial markets. It will strengthen protection for retail investors through limits on the use of commissions; conditions for the provision of independent investment advice; stricter organisational requirements for product design and distribution; product intervention powers; and the disclosure of costs and charges. It also includes changes on transparency requirements for a broader range of asset classes; the obligation to trade derivatives on-exchange; requirements on algorithmic and high frequency trading and new supervisory tools for commodity derivatives.

1.3 MiFID II entered into force on 2 July 2014 and we are required to transpose it by July 2016. Its provisions will take effect on 3 January 2017. We are seeking views early from firms and other stakeholders on a range of implementation issues, mainly focusing on retail conduct of business parts of MiFID II, to gather feedback and develop policy options ahead of formal consultation later in 2015 on the whole range of MiFID II changes.

1.4 This paper discusses the implications of certain MiFID II conduct of business and organisational requirements for firms, primarily contained within Articles 24 and 25. It also discusses certain changes we need to make to our domestic rules to implement the new minimum regulatory framework required under MiFID II for firms exempt from MiFID II ('Article 3 exempt' firms), and suggests options for alternative domestic criteria for the categorisation of local authorities. This paper does not cover implications for wholesale markets.

Who does this document affect?

1.5 This paper will be of interest to many different types of firms, including firms which undertake MiFID II business as well as some firms whose activities are not within the scope of MiFID II itself. It is of particular relevance to:

- discretionary investment management firms;
- financial advisers;
- local authorities, and firms that conduct business with local authorities;
- stockbrokers and others that provide personal recommendations to their clients on shares, bonds and/or derivatives;
- firms providing services in relation to insurance-based investments and pensions; and
- firms currently exempt from MiFID II under Article 3.

1.6 We would also particularly welcome the views of consumer advocates to help us determine the most effective approach to these policy decisions.

Is this of interest to consumers?

1.7 This paper will be of particular interest to consumers who currently access financial advice or wealth management services, and may also be of general interest to consumers who engage with other investment services.

Context

1.8 The first Markets in Financial Instruments Directive (MiFID I), implemented in 2007, established the current regulatory framework for investment services and activities, covering markets in financial instruments very broadly. It included key investor protection provisions such as suitability and appropriateness tests that applied for firms selling certain types of products. It also established rules requiring best execution of client orders and placing restrictions on the payments that a firm can receive or make when delivering services to clients. We developed a new sourcebook for conduct of business (COBS) rules for investment business as a result of these changes.

1.9 MiFID II was published in the Official Journal of the European Union in June 2014, setting out new obligations and revised requirements for both retail and wholesale markets. Many of the new rules address risks in the wholesale market, such as controls on algorithmic trading, position limits in commodity derivatives markets and the regulation of data reporting services.

1.10 MiFID II also addresses conduct of business and organisational standards. Some of these new requirements strengthen existing rules, such as tightening rules on inducements, while other measures put in place new rules covering areas such as product governance, recording of telephone conversations and electronic communications, sales staff remuneration, and the application of conduct of business standards to structured deposits.

1.11 For further details of MiFID II and the obligations for firms, please visit our dedicated pages on MiFID II at: www.fca.org.uk/firms/markets/international-markets/mifid-ii.

1.12 MiFID II is being implemented to a challenging legislative timetable, and its provisions will take effect from 3 January 2017. We expect the Level 2 implementing measures (or 'delegated acts') to be finalised by the European Commission (Commission) later this year. We then expect to publish our Consultation Paper (CP) on domestic Handbook changes across both retail and wholesale markets issues towards the end of 2015, before confirming final rules by July 2016 (the transposition deadline).

1.13 This paper discusses some – but by no means all – of the obligations under MiFID II that many firms will need to implement. We recognise there are many challenges for industry to implement the full package of MiFID II measures by January 2017.

1.14 Given these timetable challenges, we want to engage with stakeholders as early as possible in the transposition process. We are setting out our thinking on a number of areas where we have policy choices to make in our implementation of MiFID II. For some of these areas, we may need to discuss with the Commission the need to make any notifications under MiFID II. Other choices concern how we best maintain a clear and consistent regulatory regime for those products in the same relevant market as MiFID II financial instruments.

1.15 As well as discussing topics where we have choices to make, we also highlight some important changes that MiFID II is likely to require of firms within its scope. We discuss in Chapter 10 the likelihood of tougher third party inducement standards for MiFID business, for both advised and non-advised sales[1], and ask for views on maintaining domestic consistency. And in Chapter 11, we explore the likely consequences of new criteria for 'complex' products.

1.16 MiFID II maintains the existing regime which requires the categorisation of clients either as 'retail', 'professional' or, for some types of business, 'eligible counterparty'. MiFID II's conduct of business requirements in Articles 24 and 25 apply to both retail and professional clients and, in certain limited cases, to business with eligible counterparties. Unless otherwise stated in the relevant chapter, our policy choices relate to business with both retail and professional clients.

1.17 Alongside domestic consideration of the issues arising from MiFID II, we continue to work closely with HM Treasury and the various European bodies on the Level 2 implementing measures.

1.18 Stakeholders should note that the policy options considered in this paper are subject to the finalisation of those Level 2 implementing measures, which the Commission is likely to confirm later in the year. While much of the discussion in this paper is around the requirements contained in MiFID II, where relevant we have flagged the approach to implementation proposed by ESMA in its technical advice to the Commission (noting, of course, that this may not be followed by the Commission).[2] We also note that the exact legal form of the Level 2 implementing measures is currently unknown, and this may also affect our domestic decisions regarding implementation.

1.19 As well as being subject to the final Level 2 implementing measures, certain options for implementation would be subject to an analysis of the need to make a notification to the Commission under MiFID II Article 24(12). Article 24(12) allows additional requirements to be imposed on firms subject to certain conditions within that Article being met. In addition, we note that the Insurance Mediation Directive (IMD) is currently being reviewed, with a view to being recast as the Insurance Distribution Directive (IDD), due to take effect some time after MiFID II. Where we discuss rules that relate to products within the scope of the IDD, our approach here is also subject to this directive being finalised.

1 This paper does not discuss the application of the inducement rules in the context of the receipt of research by portfolio managers linked to their execution arrangements with brokers, on which we have already set out our views in our Feedback Statement on DP14/3 – *Discussion on the use of dealing commission, FS15/1, 2015*

2 *Technical advice to the Commission on MiFID II and MiFIR*, ESMA /2014/1569, 2014

1.20 While we would encourage stakeholders to bear these points in mind, we believe that an early discussion, notwithstanding these uncertainties, allows us to consider views to feed into our policy development. Any developments that may impact on our policy choices will be highlighted in our CP later in the year.

1.21 For further information on key milestones please visit: www.fca.org.uk/static/fca/documents/mifid-ii-timeline.pdf

Summary of the discussion

1.22 This paper outlines our policy choices relating to MiFID II transposition in a number of areas. We anticipate that many firms will have an interest in several of these topics. This paper invites feedback on the following areas:

- Chapter 2 explores the extent to which we apply MiFID II provisions to insurance-based investment products and pensions, particularly in light of the emerging IDD.
- Chapter 3 sets out three options for how we incorporate MiFID II's investor protection measures for structured deposits into our Handbook.
- Chapter 4 seeks feedback on whether we should look to ban discretionary investment management firms from accepting commissions and other benefits.
- Chapter 5 sets out our proposed policy options for changes to the criteria for local authorities to be treated as elective professional clients.
- Chapter 6 details MiFID II's approach to adviser independence, and discusses how we adopt new requirements for independent advice on shares, bonds, derivatives and structured deposits.
- Chapter 7 explores the extent to which we could apply MiFID II's remuneration rules for sales staff and advisers to non-MiFID firms, in light of domestic and European policy developments.
- Chapter 8a identifies where we need to make changes to our existing regime for the recording of telephone conversations and electronic communications, to implement a regime for the purposes of Article 3 of MiFID II which is 'at least analogous' to that established under Article 16(7), and invites views on how this may apply in practice.
- Chapter 8b sets out our proposal to remove the current exemption from the rules on the recording of telephone conversations and electronic communications for discretionary investment managers in our domestic regime.
- Chapter 9 discusses practical aspects of implementing and aligning MiFID II's requirements relating to costs and charges disclosures.
- Chapter 10 sets out the likely approach to the enhanced MiFID II inducements rules for advisers, discretionary investment managers, and other firms.[3]

3 Excluding the issue of the receipt of research by firms in relation to independent investment advice or portfolio management services, which was discussed in FS15/1, FCA, 2015

- Chapter 11 sets out the likely restrictions on products able to be classified as 'non-complex', and discusses the practical application of the appropriateness test.

Next steps

1.23 We would welcome feedback from firms, industry and consumer groups, and other stakeholders on the questions in this DP (see Annex 1).

1.24 Responses will feed into further policy development ahead of consulting on the full set of Handbook changes later in the year.

What do you need to do next?

1.25 We want to know what you think about the policy options set out in this paper, their impact on your business and on consumer outcomes. Please send us your comments by 26 May 2015 via the online response form, or by writing to us at the address on page 2.

What will we do?

1.26 We will consider feedback received and formally consult later in 2015 on rule changes, ahead of finalising rules in 2016. Feedback from this paper will be provided, where relevant, in our CP.

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

2.1 The scope of financial instruments to which MiFID II applies is broadly equivalent to MiFID I. MiFID II therefore continues to apply to the provision of services and performance of activities relating to those financial instruments listed in Annex I of MiFID II, including shares, money-market instruments, units in collective investment schemes, and most types of financial derivatives, but not to insurance-based investments and personal pensions.[4] We therefore have policy decisions to make on our domestic approach to insurance-based investments and pensions, both in terms of whether we maintain consistency generally, and specific conduct of business rules and organisational requirements.

Current regime

2.2 Although not subject to MIFID I, we already apply most of our conduct of business (COBS) rules which implement its requirements to insurance-based investments and pensions in the UK. These products are generally viewed as being in the same relevant market as, and therefore often substitutable with, MiFID II investment products.

2.3 Manufacturers and distributors of insurance-based investments and pensions are therefore currently subject, to a large extent, to the same COBS rules that apply to the conduct of MiFID II business. These include rules on suitability, client reporting, and third party inducements. Applying a consistent regulatory regime helps maintain a consistent level of protection for clients and mitigates against regulatory arbitrage and any resultant distortions in competition between substitutable products.

2.4 Insurance-based investment products and most pension products are also within the scope of our definition of a 'retail investment product' (RIP) and are therefore subject to the rules put in place by the Retail Distribution Review (RDR), including rules on how advice services are described, in Chapter 6 of COBS. This means that independent advisers currently have to consider these products before making a personal recommendation to their client, if these products are part of the relevant market for a particular client. We discuss the independence standard further in Chapter 6 of this paper.

The extent of substitutability

2.5 In determining our approach to insurance-based investments and pensions, we are focussing on the degree to which they are 'substitutable' for MiFID II investment products. If consumers and

4 Insurance-based investments cover products packaged under insurance contracts, such as unit-linked and with profits policies, investment bonds, personal pensions provided by insurers, and annuities.

firms sometimes treat these products as credible substitutes for MiFID II investment products, we believe it is proportionate and appropriate to continue to apply similar conduct of business rules to their manufacture and distribution.

2.6 Evidence continues to show us that these products can be substitutable. Recital 87 of MiFID II confirms that insurance-based investments are often made available to consumers 'as potential alternatives or substitutes' to MiFID II products. MiFID II, therefore, makes clear that consistent consumer protections are important between MiFID II and insurance-based investment products. That said, MiFID II notes that due to differing 'market structures and product characteristics', detailed investor protection requirements for insurance-based investments should be set out through the revised Insurance Mediation Directive (retitled the IDD), which is expected to include MiFID II style rules for these products.

2.7 The PRIIPs Regulation[5] sets out standardised pre-contract product disclosures in the form of a 'key information document'. The scope of PRIIPs includes both relevant MiFID II investment products - such as investment funds and structured investment products - as well as insurance-based investment products. The Commission commented in its assessment of the impact of the PRIIPs Regulation that it is "clear that, from the perspective of the retail investor, all these products perform comparable economic functions".[6]

2.8 When developing our COBS sourcebook in connection with the implementation of MiFID I, we also chose to extend many of its rules to certain types of pension products, with the understanding that these can be substitutable with other investment products in the domestic market. We continue to believe this is the case. Indeed, we expect that the Government's pension reforms, which take effect in April 2015, are likely to increase the substitutability of insurance-based investments, pensions and MiFID II products, with consumers likely to use a much wider range of options when accessing their retirement savings.

2.9 We remain of the view, therefore, that insurance-based investments and pensions should be governed, in principle, by the same conduct of business rules as MiFID II investments.

2.10 However, we are mindful of other work that may affect some provisions for insurance-based investments, which we explore below.

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.

Insurance Distribution Directive

2.11 The sale of insurance-based investments is within the scope of the IMD, and as such will be subject to any revisions once the new IDD is implemented. While we do not yet know when IDD will come into force (or indeed when it will become effective), it seems unlikely that its provisions will take effect until at least a few months after MiFID II and possibly longer. We should have greater certainty over the precise requirements of the IDD and the timing of its implementation when we consult on MiFID II implementation later this year.

5 *Packaged Retail Investment and Insurance-Based Investment Products Regulation*, 1286/2014, 2014

6 *Commission staff working document accompanying the communication from the Commission to the European Parliament and the Council - Packaged Retail Investments Products impact assessment*, SWD(2012)187, 2012

2.12 As an interim measure, due to the staggered legislative timetable between MiFID II and IDD, MiFID II amends the existing IMD (creating the so-called IMD 1.5), to impose some additional requirements on insurance mediation activities and for sales of insurance-based investment products by insurers. These requirements cover: obligations to identify and manage conflicts of interest; obligations to act fairly and honestly; and a requirement for marketing communications to be fair, clear and not misleading. They also allow Member States to apply MiFID II-style inducements standards to the distribution of insurance-based investments (see Chapter 10 for more detail on MiFID II's inducements standards).

2.13 We explore below the specific requirements that will apply to investment business carried on in relation to insurance-based investment products if we choose to read across MiFID II rules.

MiFID II obligations on suitability and client reporting

2.14 In many cases, MiFID II does not fundamentally change the requirements for firms that are currently subject to our conduct of business rules. There are relatively minor changes to rules around suitability assessments (such as requirements for firm assessments to include clients' ability to bear losses and risk tolerance) and periodic client reporting (where changes, including the frequency of client reporting, are likely to be confirmed in the implementing measures).

2.15 For suitability, MiFID II largely codifies existing ESMA guidance, so our expectations of how firms conduct suitability tests should not substantially change. If the IDD does not deliver a consistent regulatory regime for insurance-based investments, we consider that it would be appropriate and proportionate to read these changes across to insurance-based investments and pensions.

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.

Appropriateness test for non-advised sales of complex products

2.16 All 'complex' products can only be sold to a consumer either through an advised sale or through a sale following an 'appropriateness test'. This test is designed to ensure that a potential customer who does not receive advice has the knowledge and experience required to understand the risks of a given complex financial instrument. The firm is required to gather relevant information from the customer to make this assessment before a product is sold. This is discussed further in Chapter 11.

2.17 We did not apply the appropriateness test to insurance-based investment products at the time of implementing MIFID I. While we currently expect the IDD to introduce appropriateness for complex insurance-based investments, it is unclear whether it will replicate the requirements under MiFID II for its investment products.

2.18 Domestically, we will also want to consider the impact of the Government's reforms to the pensions market. Pensions liberalisation could give rise to new risks of inappropriate sales of insurance-based investments to consumers, as well as MiFID II investments, and we will continue to monitor this closely and may develop supervisory or policy solutions if concerns emerge.

2.19 We would welcome views on extending the application of the appropriateness test so that it would apply to non-advised sales of complex insurance-based investments and pensions. In doing so, we may choose to apply aspects of MiFID II's test to determine when such products should be treated as 'complex' (e.g., by virtue of having a structure making it difficult to understand the risks involved, or products that embed a derivative, or on the basis of any test established in the implementing measures).

2.20 We would welcome feedback on whether requiring firms to assess the knowledge and experience of prospective purchasers before selling specific types of insurance-based investments and pension products would promote better consumer outcomes.

> **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?**

> **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?**

Product governance and remuneration standards for sales staff and advisers

2.21 MiFID II requires firms within its scope to put in place arrangements to ensure products are designed for a specific target market, and to take reasonable steps to ensure that a product is distributed to this identified target market. While – at a high level – this replicates our existing expectations domestically for all firms to design products and services that respond to consumer needs[7], MiFID II's implementing measures are likely to set specific criteria for firms to identify this target market, and to set out clear management oversight of this process. Importantly, MiFID II also places new obligations on product distributors to understand products before they are offered to clients, to assess the compatibility of products with the needs of their clients, and to ensure products are offered only when this is in the interests of the client - even where no advice is being given.

2.22 MiFID II also puts in place new obligations for the remuneration of sales staff and advisers, requiring firms in scope to ensure they do not remunerate staff in a way that conflicts with the duty to act in the best interests of their client, or that creates strong incentives for sales staff and advisers to sell products inappropriately. The obligations at Level 2 are likely to be high-level, but include provisions for firms to ensure management responsibility for remuneration policies, and also that firms manage any conflicts of interests that arise through their remuneration structures. We discuss this issue further – and the potential to extend the application of MiFID II's standards to a wide range of other firms not in scope of MiFID II - in Chapter 7.

7 *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD)*, FCA

2.23 The requirements relating to product governance and sales-staff remuneration are new in MiFID II, although they are similar – at a high level – to current standards in the UK. While we currently expect the IDD to also address both areas, there is no guarantee that its provisions will be consistent with MiFID II. If they are not, we will explore whether any differences in scope should be addressed domestically.

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, or of not doing it?

Disclosure of costs and charges

2.24 MiFID II introduces updated requirements for firms to disclose all costs and charges associated with an investment service and financial instrument that are not caused by the occurrence of underlying market risk. Firms will need to aggregate this information to allow a client to understand the overall costs and the cumulative effect of these costs on the return of their investment.

2.25 This provision will change the way information is presented and provided to consumers, primarily at the point of sale, but in certain cases on an annual basis. This information should enhance investor protection by ensuring consumers are aware of all the costs and charges they incur in the provision of MiFID II products and services. We explore some implementation issues for MiFID II firms in Chapter 9.

2.26 We recognise there are a number of changes to disclosure requirements for insurance-based investments and pension products under development. This includes:

- as part of the IDD, consideration is being given to whether a costs and charges disclosure requirement, similar to that in MiFID II, should be applied to insurance-based investments;
- a new European Union wide pre-contractual disclosure Key Information Document (KID) is being developed for PRIIPs with a Regulation coming into effect from 31 December 2016; and
- enhanced transparency of costs associated with workplace pension schemes to help ensure they deliver value for money for savers. As part of this, the FCA and DWP have recently published a joint call for evidence looking at how transaction costs should be reported in this market.[8]

2.27 Reflecting these developments, and the wider changes to the UK pensions landscape, we do not consider it appropriate to apply the MiFID II costs and charges requirements to insurance-based investments and pensions at this stage.

8 *Transaction costs disclosure: improving transparency in workplace pensions*, DP15/2, 2015

Independence and inducements

2.28 Finally, there are some aspects of MiFID II where we have already applied rules to insurance-based investments and pensions to increase consumer protections domestically. We explore whether we should retain insurance-based investment products and pensions in our definition of RIPs in the context of independent investment advice in Chapter 6. We also explore the potential impact of MiFID II's revised inducements standards in Chapter 10, and the extent to which we maintain a consistent regime for insurance-based investments and pensions.

3. Treatment of structured deposits

3.1 Under MiFID II, firms selling or advising clients in relation to structured deposits[9] are subject to many of the investor protection provisions and organisational requirements in MiFID II. This chapter focusses on MiFID II's conduct of business requirements in Articles 24 and 25, and considers how we apply those requirements domestically to structured deposits.

MiFID II obligations

3.2 The Commission regards structured deposits as having a similar 'economic effect' to other MiFID II products[10], and has therefore extended the application of MiFID II's investor protection requirements to sales of, and advice on, these products. Many of MiFID II's conduct of business and organisational requirements will now apply to structured deposits, imposing a variety of new obligations on their manufacture and sale. These new obligations include suitability and appropriateness tests, rules on inducements, product governance and staff remuneration requirements, cost and charges disclosures, and post-sale reporting obligations.

3.3 MiFID also specifies when structured deposits are deemed 'complex' and therefore cannot be sold 'execution only'. Structured deposits that incorporate a structure that makes it difficult for the client to understand the risk of return or the cost of exiting the product before term, will automatically be considered 'complex'.

3.4 We would encourage firms currently manufacturing and selling structured deposits to ensure they understand these new requirements and how they may impact their existing product offering. Further discussion of the likely effects of MiFID II's new standards for 'complex' products more generally can be found in Chapter 11.

Our domestic approach

3.5 Given that MiFID II brings structured deposits in scope of its investor protection rules, we need to decide how to incorporate these into our domestic rules.

3.6 We currently regulate these products through the Principles for Businesses and our Banking Conduct of Business sourcebook (BCOBS), which contains rules and guidance on how these products should be promoted and sold.[11] However, MiFID II brings them into scope of a range

9 Deposits which are fully repayable on maturity, on terms under which interest or a premium is paid or is at risk according to a prescribed formula (typically involving the performance of an index, stock, or commodity.

10 *Commission staff working paper impact assessment*, SEC(2011)1226 final, 2011

11 *Retail product development and governance - structured product review*, FG12/09, 2012. We have also recently published *Structured products: thematic review of product development and governance*, TR15/2, 2015 and *Occasional Paper No 9: two plus two makes five? survey evidence that investors overvalue structured deposits*, 2015

of existing conduct of business and organisational rules that currently apply to investment business through our COBS sourcebook.

3.7 We support the Commission's view that these products have a similar economic effect as MiFID II investment products. We also note the Commission's work developing the PRIIPs Regulation, which also includes structured deposits in its scope by virtue of their delivering the same 'economic function' as other investment products. This evidence suggests that a consistent regulatory regime for these products would help to prevent distortions in competition and prevent regulatory arbitrage.

3.8 We are seeking views on three broad options for our future regulatory approach to these products.

3.9 First, we could copy out the relevant MiFID II provisions into our BCOBS sourcebook, only applying them to firms advising on and selling structured deposits. However, as described above, there is very limited overlap currently between BCOBS and the relevant MiFID II conduct of business rules, so copying out (or otherwise incorporating) the host of MiFID II requirements into BCOBS, which would not apply to deposits more generally, would considerably expand BCOBS and risk making our requirements unnecessarily complicated for firms and consumers to understand. In addition, as we outline further in Chapter 6, we are also seeking views on including structured deposits in our definition of RIPs. This may also have an impact on the complexity of Handbook changes if we chose to copy out the relevant MiFID provisions into BCOBS. Given these points, this is not an option we currently favour.

3.10 A second option would be to apply relevant MiFID II-derived requirements to structured deposits through COBS, turning on only the relevant MiFID II provisions (whilst retaining relevant BCOBS rules and guidance). The non-relevant parts of COBS would need to be expressly dis-applied to structured deposits.

3.11 A third approach would be to incorporate these products fully into COBS (whilst retaining relevant BCOBS rules and existing guidance), effectively switching on both the MiFID II requirements and some additional rules (i.e. rules that MiFID II would not automatically switch on). These would include some additional rules on client communications. Standardising our requirements for these products may bring simplicity and consistency for firms, reduce consumer confusion, and remove the possibility of regulatory arbitrage (particularly given the evidence that these products perform the same economic function as MiFID II investment products).

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

4. Receipt of commissions and other benefits for discretionary investment managers

4.1 'Portfolio management' is defined in MiFID II as 'managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments'.

4.2 Domestically this relates to firms that conduct business through the 'managing investments' regulated activity. This is typically described domestically as 'discretionary investment management' (DIM) activity, and we use this terminology in this paper.[12] This chapter relates to business conducted for retail clients only.

Current regime

4.3 Portfolio management is an investment service within the scope of MiFID II, and many of our domestic conduct of business rules for discretionary investment managers derive from MiFID I. These rules apply various requirements to the conduct of such business including in relation to client categorisation, communications and financial promotions, suitability assessments and reporting and disclosure requirements.

4.4 We only applied RDR rules in situations where personal recommendations are given to retail clients on RIPs. As such, firms that receive a mandate from a client to make investment decisions on their behalf are not within scope of the RDR rules (for this particular activity).

MiFID II obligations

4.5 Many of MiFID II's requirements involve updating, where necessary, existing conduct of business obligations. These include updating the relevant requirements for suitability assessments, and pre and post-sale reporting.

4.6 Some obligations however are new, and firms are likely to need to develop systems and make organisational changes to ensure compliance. Firms should particularly note the requirements relating to the remuneration of sales staff (see Chapter 7 for more details) and the likely new restrictions on the nature of acceptable third party inducements (we discuss these requirements more generally in Chapter 10).

12 This paper concerns rules applicable to MiFID II firms providing the service of portfolio management. Rules applicable to AIFMs and UCITS management companies are established under different legislation.

4.7 MiFID II bans discretionary investment managers from accepting and retaining third party commissions, fees and monetary and non-monetary benefits[13], effectively applying requirements similar to aspects of the RDR adviser charging rules to DIM activities. However, unlike our RDR rules applicable to investment advisers, MiFID II allows discretionary investment managers to receive payments from third parties if these are passed on to clients in full (in effect allowing rebating).

Our domestic approach

4.8 While MiFID II bans retaining third party commissions and other benefits, it allows firms to accept these payments, provided they rebate these back to the client as soon as possible after receipt. We want to seek views on whether consumer outcomes would be improved by putting in place similar rules to the RDR and banning the acceptance of such commissions, fees and benefits, and therefore, client rebating, for DIM activities.

4.9 When developing the RDR, we explored the consumer benefits of banning rebating generally. Our consultation on 'Delivering the RDR'[14] explored the risks of allowing rebating when advisory firms are giving a personal recommendation to their clients. We explained that accepting payments could still allow the potential for advice to be biased, potentially undermining trust. If a firm can accept payments and rebate these to the client, there may still be an incentive to select commission-paying products, as the commission could then be rebated back to the client. This could give the impression of 'discounted' charges, when compared to non-commission paying (and potentially cheaper) products.

4.10 Last year, we took a similar approach to restricting cash rebates from platforms. This work also described the risks of consumer confusion, with clients not being aware that money in a cash account was their money and not just a mechanism for paying the adviser. There was also a potential for services to be seen as 'free' or 'funded by products that paid a rebate'. Cash rebates (above a nominal amount) to consumers from providers and platforms were banned from April 2014.

4.11 In both cases described above we saw the potential for rebates to distort consumer outcomes and provide incentives for advisers and platforms to sell commission-paying funds as opposed to funds with no in-built commission, which could have meant consumers were not getting the best possible product to meet their needs.

4.12 Allowing rebating for DIM firms may create the potential for consumer confusion and regulatory arbitrage. Firms may seek out commission-paying share classes and then rebate the commission to their clients, seemingly reducing fees and creating confusion among clients about the true cost of both the product invested in and the DIM services. It is also important to note that any rebates (either cash or unit rebates) are likely to be subject to income tax, so may also be unfavourable to clients without a tax-efficient wrapper.

4.13 We would welcome feedback from firms on the practical implications of banning rebates. We expect that many DIMs will be applying RDR standards to their existing business for various reasons, and will prefer regulatory consistency, with differing standards risking creating additional costs and complexities for firms, which a simpler and more consistent regulatory

13 Except for certain 'minor non-monetary benefits' discussed in Chapter 10

14 *Distribution of retail investments: delivering the RDR, CP9/18*, 2009

approach would prevent. Firms may also prefer to avoid the costly systems changes that may be needed to match rebates to individual clients.

4.14 As well as firms providing DIM services, it would be helpful get the views of fund managers and platforms. Retaining separate classes of funds that pay commission may create additional costs and complexities for these firms.

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

4.15 As well as exploring a total ban (similar to the approach we took for advisers), we would also like views on whether we should look to develop a regime similar to our approach to platforms, banning cash rebates (other than small amounts) but allowing rebates to be given back to clients in units.

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

5. Professional client business – client categorisation and treatment of local public authorities and municipalities

5.1 This chapter explains the changes under MiFID II relating to the categorisation of local public authorities and municipalities (together referred to as 'local authorities').

5.2 MiFID II categorises local authorities (excluding those that manage public debt at the national level[15]) as retail clients with the ability to request to opt-up to elective professional status where they meet the qualifying criteria. However, MiFID II gives Member States the discretion to adopt specific alternative or additional criteria for the assessment of the expertise and knowledge of local authorities requesting to be treated as elective professional clients.

5.3 This chapter sets out potential policy options for changes to the opt-up criteria for local authorities requesting to be categorised as elective professional clients and invites stakeholders' views on these as well as the potential impact. Given the discretion MiFID II confers on Member States, we need to consider whether the existing opt-up regime is fit for purpose in determining whether local authorities have the expertise and knowledge to be treated as professional clients. Alternatively, we could consider introducing additional or alternative opt-up criteria for local authorities.

5.4 We are also considering amending our rules to the effect that local authorities are categorised as retail clients in respect of non-MiFID business, given that the same risks may apply. This would also ensure simplicity and avoid the need for two sets of parallel requirements.

5.5 MiFID II puts a particular focus on increasing protections for local authorities and municipalities. The financial crisis and alleged mis-selling practices involving local authorities (e.g. in France , Italy and the UK) revealed that some local authorities may not fully appreciate the risks they are exposed to, especially in the case of complex financial products.

Our current domestic regime

5.6 When first implementing MiFID I's client categorisation regime in 2007, the FSA set out its view as to how local authorities should be categorised in COBS 3.5.2A R.

15 In the context of Annex II.I(3), MiFID II clarifies that local authorities do not fall within the scope of national and regional governments, including public bodies that manage public debt at the national or regional level, which continue to be categorised as *per se* professional clients.

5.7 Under the existing regime for MiFID business, the FCA's position is that a local authority may be categorised as a per se professional client if it meets the existing MiFID test for large undertakings in COBS 3.5.2 R (2). According to the large undertakings test, in order to be categorised as a per se professional client an entity must meet two of the following size requirements, on a company basis: (a) balance sheet total of €20,000,000; (b) net turnover of €40,000,000; or (c) own funds of €2,000,000. Where a client, such as a local authority, does not fall within one of the categories of client who are considered to be professional per se, it is by default categorised as a retail client. As a retail client, it has the ability to request to be treated as an elective professional client where it meets the specific opt-up criteria. The criteria for opting-up to elective professional client status are set out in COBS 3.5.3 R. The changes under MiFID II mean that it is no longer possible to treat local authorities as per se professional clients on the basis of meeting the large undertakings test and so COBS 3.5.2A R must be amended.

5.8 For non-MiFID business, local authorities are categorised as per se professional clients, subject to no restrictions, as provided in COBS 3.5.2 R (3)(f). This provision would be deleted should we decide to categorise local authorities as retail clients for the purposes of non-MiFID business.

Background on local authorities in the UK

5.9 Local authorities in the UK vary in their financial skills and competencies, ranging from large city councils with established treasury management functions to smaller, less experienced local authorities or parishes.

5.10 It is our understanding that local authorities, in general, manage large multi-million pound cash flows– a number of larger councils have portfolios in excess of £100 million while smaller ones might manage cash flows of around £10 million. From our stakeholder engagement, we understand that approximately 60% of the portfolios of local authorities comprise cash deposits (which are non- MiFID instruments), followed by money market funds.

5.11 During our stakeholder engagement, local authorities' representatives explained that most local authorities are currently majority invested in bank or building society deposits (which are non-MiFID instruments). However, going forward, they expect to increase their investments in MiFID financial instruments, particularly secured debt instruments (e.g. bonds, commercial paper and certificates of deposit).

5.12 In view of the anticipated move towards greater levels of investment in MiFID instruments, the question of whether the existing opt-up criteria are sufficiently robust to ensure that only those local authorities with the necessary expertise are able to elect to be categorised as professional clients is of particular relevance.

Proposed options for amending the opt-up criteria for local authorities

5.13 We outline below three possible options for exercising our discretion in relation to the opt-up regime for local authorities on which we invite comments from stakeholders. While our initial preference is to strengthen the opt-up criteria for local authorities requesting to be treated as professional clients (as described in options B and C, below), we will only finalise our policy position once we have considered stakeholder responses.

Option A: no change to the existing opt-up criteria for local authorities (for both MiFID and non-MiFID business), but provide guidance on aspects of it

5.14 This option proposes that the existing opt-up criteria (consisting of both a qualitative and quantitative assessment and specific procedural requirements) for electing up to professional client status are fit for purpose for local authorities and no specific additional or alternative criteria are required. We may propose, however, further guidance on the qualitative test.

5.15 Under the existing opt-up regime, retail clients can elect to be treated as professional clients (either generally or in relation to one or more particular services or transactions), provided that certain qualitative and quantitative criteria are met. The purpose of this assessment is to ensure that the client agreeing to waive the protections otherwise afforded to retail clients has the necessary expertise, experience and knowledge to make his or her own investment decisions and to understand the risks involved. It is up to the investment firm to determine whether its client meets the qualitative and quantitative elements of the assessment.

5.16 The qualitative assessment requires the investment firm to undertake 'an adequate assessment' of the expertise, experience and knowledge of the client to give 'reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved' (COBS 3.5.3 R (1)).

5.17 In the course of that assessment, the client must satisfy at least two of the following quantitative criteria (in relation to MiFID business): (a) the client has carried out transactions, in significant size, on the relevant market at an average frequency of ten per quarter over the previous four quarters; (b) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds €500,000; (c) the client works or has worked in the financial sector for at least one year in a professional position which requires knowledge of the transactions or services envisaged.

5.18 The criteria are readily understood and accepted industry practice following the implementation of the client categorisation rules in 2007. This option would have minimal impact on firms, as no changes to the existing procedures for assessing opt-up requests from retail clients would be required. This option is administratively simple and potentially cost-effective for the industry.

5.19 Based on our discussions with industry stakeholders, including local authorities' representatives, we understand that most local authorities, by virtue of their business models and portfolio size, could meet two of the three limbs (limbs b and c) of the quantitative test (including those local authorities that may not, in qualitative terms, possess the relevant knowledge, experience and expertise). This could suggest that the quantitative element of the assessment may not be fully effective in determining the level of expertise and knowledge of local authorities.

5.20 As a consequence, the qualitative element of the opt-up test may be the only effective safeguard or filter for ensuring that only those local authorities that genuinely meet the standards of a professional client are able to opt-up.

5.21 To assess the knowledge and expertise of the local authority, MiFID suggests that firms could apply the fitness test applied to managers and directors of MiFID firms. We have not provided guidance in this regard on our expectations of firms when undertaking the qualitative test but if we retain the existing opt-up criteria, we will consider providing some guidance on our expectations.

Option B: introduce new rules – strengthen the quantitative element of the opt-up criteria for local authorities for MiFID business

5.22 In order to mitigate the potential risk of local authorities being treated as professional clients merely by virtue of their business models rather than based on their expertise and knowledge, we are considering strengthening the opt-up criteria for local authorities or introducing alternative criteria. This could be achieved by:

- **i.** requiring local authorities to meet all three elements/limbs of the quantitative test rather than just two, to opt-up to elective professional client status; and/or
- **ii.** increasing the portfolio size requirement for local authorities to €20 million, given that smaller local authorities typically have a portfolio size of up to £10 million. This would help in ensuring that local authorities that should otherwise be categorised as retail clients are not able to opt-up merely by virtue of their portfolio size rather than based on their knowledge, experience and expertise.

5.23 Option B would reinforce the quantitative criteria for local authorities without being obstructive to local authorities that can genuinely be considered professional clients. Local authorities that do not necessarily possess the knowledge and expertise to be categorised as professional clients would not easily meet the quantitative test automatically.

5.24 This approach should not be overly restrictive or obstructive for local authorities requesting to opt-up to elective professional client status, nor would we expect this to be onerous for firms to implement as part of their procedures when assessing opt-up requests from local authorities.

Option C: change our rules - strengthen the opt-up regime for local authorities so that the alternative quantitative opt-up criteria for local authorities mirror the MiFID large undertakings test

5.25 We could use our discretion to strengthen the quantitative element of the opt-up criteria by adopting the MiFID large undertakings test (used for per se professionals). So along with the qualitative criteria, local authorities would have to meet the size thresholds of the large undertakings test in order to opt-up to elective professional status.

5.26 The MiFID large undertakings test imposes a higher quantitative threshold than the MiFID elective professional regime, given the larger size requirements that clients must meet to be categorised as per se professionals. Using this approach would mean that only those local authorities that are already categorised as per se professionals under our existing regime would be able to opt-up (subject to satisfying the qualitative test). Those that do not would remain categorised as retail clients.

5.27 Option C probably provides a higher level of investor protection, given that only local authorities that meet the thresholds of the large undertakings test and the qualitative test would be eligible to opt-up to elective professional client status. This option would present limited changes for local authorities or firms from the current client categorisation practices and procedures.

Extending the retail categorisation of local authorities to cover non-MiFID business

5.28 In implementing the re-categorisation to retail client status of local authorities under MiFID II we propose that local authorities are categorised as retail clients with the option to opt-up to elective professional client status for both MiFID and non-MiFID business. This has the advantage of simplicity, avoiding the need for two sets of parallel requirements. We would clarify that in doing so, we would continue to apply the elective professional criteria for non-MiFID II business in line with our existing requirements (i.e. the quantitative element of the test is not applied in relation to non-MiFID II business as provided in COBS 3.5.3 R (2)). Therefore this proposal would not extend the MiFID opt-up criteria (including the quantitative assessment) to local authorities with respect to non-MiFID business.

5.29 While our initial preference is to strengthen the opt-up criteria for local authorities requesting to be treated as professional clients (as described in options B and C), we will only finalise our policy position once we have considered stakeholder responses.

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?

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.

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

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

6. Adviser independence

6.1 MiFID II introduces a European-wide standard for 'independent advice' for the first time. This focuses on ensuring that firms offering independent advice do not limit the products considered to those of the advisory firm, or firms with close links to the advisory firm, to prevent any potential bias that may occur.

6.2 This chapter explores MiFID II's requirements in light of our existing independence standard in terms of both the range and types of products that an independent adviser must consider before making a personal recommendation to their client. The issues we explore in this chapter relate to business conducted for retail clients only.

Range of products to be considered

6.3 MiFID II requires firms offering independent advice to assess a "sufficient range of different product providers' products…prior to making a personal recommendation". We expect the criteria for ensuring that products and providers are 'sufficiently diverse' to be established by the Level 2 implementing measures later in 2015. ESMA's technical advice suggests that independent advisers should consider a range of financial instruments proportionate to the scope of advice, and adequately representative of the products available on the market.

6.4 While MiFID II's rules have been developed to address potential product and provider bias, our existing rules – brought in as part of the Retail Distribution Review (RDR) - aim to ensure that independent advisers look at a wide range of different types of products from different product providers, so that firms provide a 'comprehensive and fair analysis' of potential products in a relevant market.

6.5 Our domestic rules were the result of a detailed analysis of the advisory market in the UK. We identified the high reliance that UK consumers place on the personal recommendations they receive from financial advisers, and – through consumer testing – identified that consumers consider 'independent advice' to be both free from provider bias, and for any personal recommendation to be the result of a 'thorough search of the whole market'.[16] Our current standard for the scope of independent advice was therefore developed with these principles in mind, reflecting the advice market domestically.

16 *Exploration of consumer attitudes and behaviour with regard to financial advice and the implications of RDR proposals*, GfK research commissioned by the FS Consumer Panel, 2008

6.6 As well as a 'comprehensive and fair analysis', we also introduced a concept, similar to MiFID II, of a 'relevant market'. This means that firms can hold themselves out as providing independent advice in a particular relevant market, and provide a 'comprehensive and fair' analysis of products in that particular market. So, for example, a firm could be an independent sharia adviser – giving advice on Sharia-compliant products only, or an independent ethical adviser. Under our current rules, therefore, firms holding themselves out as providing 'independent financial advice' generally will require a comprehensive and fair assessment of all types of RIPs in that market.

6.7 As we explore in more detail below, our definition of 'retail investment product' is intentionally broad, covering a range of MiFID II (for example, UCITS and structured products) and non-MiFID II (for example, insurance-based investments) products that may be suitable for a retail investor.

6.8 Where independent advice is sought, we continue to believe that consumers should receive advice that considers all types of products that may be suitable for their needs. We understand, however, that some stakeholders consider MiFID II's standard – a 'sufficient range' of products from a sufficiently diverse group of providers – may allow independent financial advisers to redefine the breadth of products they need to consider before providing a personal recommendation.

6.9 We would welcome views on this point – in particular, on how far MiFID II's standard is practically different to our existing standard, particularly from firms holding themselves out as 'independent financial advisers'.

6.10 We need to ensure that any independence standard is clear, both to firms and consumers. We already know that consumers understand independent financial advice to cover a range of products. We have worked hard over the last couple of years to ensure a consistent approach for firms delivering advice, and have worked with firms to ensure that consumers understand what service they are getting when they seek advice from an independent adviser. While our recent post-implementation review of the RDR shows that we continue to have work to do in ensuring consumers understand and engage effectively in this market, any material change in our expectations risks creating more consumer and industry confusion.

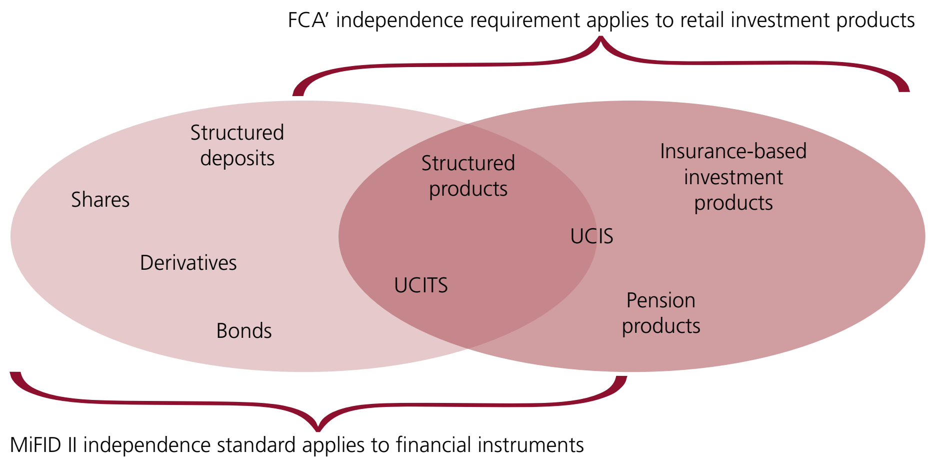
Q13: Do you consider that MiFID II's standard of independent advice is different, in practice, to the UK's RDR standard? If so, please explain why.

6.11 In the RDR post-implementation review, we identified that consumer understanding of the adviser labels could be enhanced. We committed to working with stakeholders to consider better ways to present information to consumers on the nature of advice services. We will explore this topic further in a forthcoming discussion paper looking at the wider provision of information to consumers.

Types of products covered by an independence standard

6.12 As we discuss above, our existing independence requirements cover all RIPs, which include investment products in scope of MiFID II (structured products and UCITS), and some products outside of scope (insurance-based investments and personal pensions).

6.13 The diagram below shows the overlap between our existing independence requirements in relation to RIPs, and the products that MiFID II's independence standard covers.



Independent advice on shares, bonds and derivatives

6.14 As the diagram shows, MiFID II requires us to deliver an independence standard for advice on shares, bonds, and derivatives, products that currently sit outside our definition of RIPs.

6.15 We do not consider it proportionate to include shares, bonds and derivatives in our existing definition of RIPs. Doing so would risk significantly increasing the market search costs and knowledge needed for independent advisers covering RIPs, without any obvious consumer benefits. Instead, we want to explore an appropriate way of implementing MiFID II's standard for these products domestically.

6.16 MiFID II requires firms to be able to offer independent advice on a sufficient range of shares, bonds and/or derivatives from a sufficiently diverse range of providers. We would expect firms to clearly disclose the scope of the service provided to a client, and ensure the client fully understood the extent of the independent advice being offered. It would seem reasonable that a firm offering independent advice based on a sufficient range of shares, if accurately communicated to their client, could ensure they met their client's expectations in terms of the breadth and range of services offered.

6.17 We are mindful, however, that this approach could lead to several new ways in which firms hold themselves out – firms holding themselves out as providing independent advice on shares, or bonds, or derivatives, or indeed any combination of these. This may lead to consumer confusion, and require the consumer to select – at least initially – the type of product they believe is suitable for them. It is unclear to us at this stage if this would deliver the optimum consumer outcome.

6.18 Alternatively, we could replicate our existing approach for independent advice on RIPs for firms to provide advice based on a 'comprehensive and fair' analysis of the relevant market. A relevant market – be it in shares, bonds, derivatives or a 'basket' of these products – in this instance would need to be carefully defined. For example, we would need to consider whether this would include both primary and secondary markets, both listed and unlisted shares, and whether this analysis would be confined to regulated markets only.

6.19 Similarly, a 'comprehensive and fair assessment' (or a requirement to this effect) would also need to be carefully considered, potentially defining this as any share, bond or derivative that would meet the client's needs, without the adviser having to consider every possible product, which would clearly be disproportionate.

6.20 Advice on shares and bonds is often provided by stockbrokers in the UK. Firms that provide advice typically either provide ongoing advice while managing a client's portfolio, or provide advice on a 'one-off' basis. Stockbrokers may also consider a wide variety of products that are classified as RIPs, but which may also trade as securities (for example, investment trusts and exchange traded funds).

6.21 One approach could be to define a sensible 'basket' of products (as we did when devising RIPs) which a firm would need to consider in order to hold itself out as independent. Most stockbrokers who provide advice would, we anticipate, be unable to meet any independence standard (be it 'sufficient range' or otherwise) for derivatives, which may lead us to consider an entirely separate standard for independent advice on derivatives to be appropriate.

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

Independent advice on insurance-based investments and pensions

6.22 Another issue is whether we should retain insurance-based investments and pension products in our definition of RIPs.

6.23 As we discuss in Chapter 2, we continue to believe that insurance-based investments and pensions are in the same relevant market as MiFID II investment products. We do not believe that a more sectoral approach to advice on these products would benefit consumers in the UK (while continuing to be mindful of any developments with IDD for insurance-based investments). We continue to note the risk, as highlighted by the Commission, of competition distortions of applying different regimes to different types of substitutable products, together with the risk of regulatory arbitrage.

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

Independent advice on structured deposits

6.24 We did not include structured deposits when we defined the scope of what constitutes a 'retail investment product'. MiFID II now addresses this by requiring Member States to include provision for independent advice on structured deposits. We therefore need to consider how advice on these products is treated domestically.

6.25 Other MiFID II rules will mean that many existing structured deposits may be considered 'complex' (see Chapters 3 and 11 for more on this topic) and therefore expect the market may change significantly over the coming years, potentially changing distribution models.

6.26 Given the evidence of substitutability with other MiFID II investment products, we believe that the most proportionate and appropriate solution for applying independent advice requirements to structured deposits would be to include them in our existing definition of RIPs. We expect that many independent advisers already consider these products, and believe that this change would result in only marginal costs for the industry.

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

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

7.1 MiFID II introduces a set of rules on staff incentives and the remuneration of sales staff and advisers designed to help prevent failures in the sales process. The rules seek to ensure sales staff and advisers are not remunerated in a way that creates incentives for staff to sell products inappropriately. Specifically, MiFID II requires that firms do not remunerate or assess the performance of their own staff in a way that conflicts with their duty to act in the best interest of their client, or provides an incentive for recommending or selling a particular financial instrument when another product may better meet the client's needs.

7.2 ESMA's technical advice contains specific measures that include,

- ensuring that firms do not create remuneration policies that create incentives that may lead relevant persons to favour their own interests or the firm's interests to the potential detriment of any client;
- ensuring management approval of a firm's remuneration policy, and for the day to day monitoring of this policy to be the responsibility of senior management; and
- for remuneration or similar incentives not to be solely based on quantitative commercial criteria, but instead take into account appropriate qualitative criteria reflecting the fair treatment of clients and the quality of services provided to clients.

7.3 This advice is largely derived from existing ESMA guidelines on remuneration policies and practices for MiFID II firms, published in June 2013.[17] These guidelines, which apply to all existing MiFID II business, set expectations on the design and governance of remuneration practices and controlling risks that remuneration policies and practices create. MiFID II's implementing measures will likely codify many of these expectations into rules.

7.4 MiFID II provides us with an opportunity to consider whether these high-level standards could also be applied to non-MiFID II firms.

Existing domestic provisions

7.5 Domestically, we currently have various provisions that directly, and indirectly, look to ensure that remuneration policies do not create incentives for employees to act in ways that are not in the best interests of the consumer.

17 *Guidelines on remuneration policies and practices (MiFID)*, ESMA/2013/606, 2013

7.6 At a high level, Principle 3 within our Principles for Businesses focusses on management and controls, requiring firms take reasonable care to organise and control their affairs responsibly and effectively, applying to all regulated firms. We would expect, at a high level, remuneration policies should comply with this Principle.

7.7 We also have detailed remuneration provisions that focus on specific types of firms depending on their risk profiles. Our Handbook (SYSC Chapter 19) contains three separate remuneration codes:

- Remuneration Code (SYSC 19A) – applying to building societies, banks, investment firms and UK branches or subsidiaries of non-EEA firms (in relation to the activities carried on from the UK establishment), implements the remuneration provisions of the CRD IV.
- AIFM Remuneration Code (SYSC 19B) - applying to UK alternative investment fund managers, implements the remuneration provisions of the AIFMD.
- BIPRU Remuneration Code (SYSC 19C) – applying to BIPRU firms. These are MiFID II firms that do not qualify as 'investment firms' under the Capital Requirements Regulation (CRR) and are subject to our national transposition of CRD III as of 31 December 2013, including the remuneration requirements.[18]

7.8 While focussing on material risk takers, the Remuneration Code contains a general requirement for firms within scope to have remuneration policies in place that are consistent with effective risk management[19], and guidance stating that if a remuneration policy is not aligned to effective risk management, it is likely that all employees (i.e. not just material risk takers) will have incentives to act in ways that might undermine effective risk management.[20] It also has guidance[21] to the effect that the regulator would expect firms, when complying with the Remuneration Code general requirement, to apply certain principles on a firm-wide basis. It then sets out several principles, as rules, including one to the effect that a firm's remuneration policy includes measures to avoid conflicts of interest.[22]

7.9 In addition, we (together with the PRA) have consulted on an additional Remuneration Code, which would apply to banks, building societies and PRA-designated investment firms (all currently captured under SYSC 19A). The consultation paper[23] set out proposed changes to the Remuneration Code to address the perceived weakness in alignment between risk and reward which was highlighted in the final report of the Parliamentary Commission on Banking Standards (PCBS), Changing Banking For Good, published in June 2013. The consultation included extending deferral periods for all material risk takers, introducing seven year clawback and a discussion on ways of addressing the practice of buyouts.

7.10 We also have domestic guidance to all firms on the risks to consumers from financial incentives[24], issued in January 2013, following a supervisory thematic review conducted across a range of authorised firms. This guidance applies more broadly than the Remuneration Code to all firms in retail financial services with staff who are part of an incentive scheme and deal directly with retail customer transactions. This guidance confirmed our expectations for firms to:

18 As a result of our exercise of the discretion in CRR article 95(2).
19 SYSC 19A.2.1R.
20 SYSC 19A.2.1.2G(1).
21 SYSC 19.A.2.3G
22 SYSC 19A.3.9R
23 *Strengthening the alignment of risks and reward: new remuneration rules*, PRA CP15/14/FCA CP14/14, 2014
24 *Risks to customers from financial incentives*, FG13/1, 2013

- properly consider if their incentive schemes increase the risk of mis-selling and, if so, how;
- review whether their governance and controls are adequate;
- take action to address any inadequacies; and
- where risks cannot be mitigated, take action to change their scheme, and where a reoccurring problem is identified, investigate, take action and pay redress where consumers have suffered detriment.

7.11 Follow up work demonstrated that there had been positive progress and significant changes made to firms' financial incentive structures as a result, and increased awareness and focus on these issues. We have continued to focus on financial incentives through our supervision of firms because it is still an important area of inherent risk, and to ensure progress is built on and the changes made to reduce risk embed.[25]

European landscape

7.12 Our current provisions are likely to be impacted by several European initiatives over the next 2 to 3 years, with European policy makers specifically addressing remuneration for particular markets, financial products and types of firms, either through other EU directives or through implementing measures or guidelines. As well as MiFID II, various legislation – for example Solvency II, IDD, Mortgage Credit Directive (MCD), CRD IV – already cover (or in the case of IDD, we expect it to cover) remuneration to varying extents (either high level in directives or through more detailed guidelines).

7.13 The MCD, for example, includes specific measures to prevent staff being remunerated in a way that impairs their ability to act in the best interests of their clients, including ensuring remuneration policies do not incentivise sales staff to undertake a specific number or types of agreements for their customers. In addition, we understand that the European Banking Authority (EBA) is also looking to develop guidelines on the remuneration of sales staff, although the scope of this is still to be determined.

Options for discussion

7.14 While we recognise the varied legislative approach at a European level, we believe that common and consistent provisions, at a high level, could be important to ensure that remuneration practices for sales staff and advisers help prevent conflicts of interests. MiFID II gives us the opportunity to consider whether we should develop cross-cutting obligations for non-MiFID II firms, based on MiFID II's remuneration standards for sales staff and advisers, regardless of the type of business they conduct.

7.15 While legislation at a European level may set similar (or analogous) requirements to MiFID II, there is currently no guarantee that they will. Other parts of the industry – for example consumer credit firms – may not be subject to further standards in the foreseeable future. We

25 For example, we have recently published a guidance consultation *Risks to customers from performance management at firms: Thematic review and guidance for firms*, FCA GC15/1, 2015

would therefore welcome views from all sections of the industry on whether cross-cutting standards, based on MiFID II, would improve consumer outcomes.

7.16 Reading across MiFID II's remuneration standards to other parts of the industry would give firms clear requirements to ensure they do not create remuneration policies that promote inappropriate incentives to staff, ensure a management body is responsible for defining and approving these policies, and ensure firms explicitly identify, prevent or manage conflicts of interest caused by remuneration structures.

7.17 On the one hand, there are likely to be several advantages with this approach. Any cross-cutting set of standards would mitigate against firms being incentivised to sell certain product lines if standards were lower in particular markets, helping to ensure a strong and consistent regime to protect consumers. Many firms, particularly those that conduct both MiFID II and non-MiFID II business, may well look to apply MiFID II's requirements across their business. Furthermore, a cross-cutting, consistent regime may reduce 'two tier' (and potentially more costly) remuneration requirement for firms, and improve consumer and industry understanding of their obligations. We also consider that it should not create large additional regulatory burdens for firms that comply with our existing domestic guidance.

7.18 On the other hand, it is important to note that this approach could apply to a wide range of non-MiFID II firms some of which may already be subject to a remuneration regime, for example banks in SYSC 19A (when not carrying out MiFID II business), or may be subject to remuneration provisions in the near future (for example insurers under Solvency II). In those cases, the development of cross-cutting provisions for remuneration of sales staff and advisers based on MiFID II standards will require further analysis to assess its compatibility with the other relevant remuneration regimes to avoid conflicting requirements. In some cases, therefore, the proposed guidance may need to be very high-level to ensure compatibility, while in others if we were to find that the existing remuneration provisions are similar or more stringent than the equivalent MiFID II standard, then the existing provisions would apply without the need for our proposed guidance.

7.19 A further option could be choosing to wait to be certain about the future EU legislative landscape before we introduce cross-cutting standards for sales staff and advisers. Adopting this approach may also allow us to 'gap fill' and level-up relevant provisions once we have greater certainty over the scope and precise requirements of the various legislative approaches. Applying additional domestic standards may also present practical differences of scope when firms passport in to the UK, that will be subject to rules in their home countries, whom we anticipate may be unlikely to adopt a similar approach to the UK.

7.20 If we were minded to pursue this approach, application of MiFID II's standards to any non-MiFID II industry sectors would need to be subject to further policy work and cost benefit analysis, which we would include in our CP later in the year.

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

8. Recording of telephone conversations and electronic communications

8a. Taping requirements for Article 3 firms

8.1 MiFID II makes several changes to Article 3 both in respect of the type of firms which can rely on the optional exemption and introduces, for the first time, a requirement on Member States adopting these optional exemptions to impose on these firms certain authorisation, supervision, conduct of business and organisational requirements[26], which are 'at least analogous' to those under MiFID II. The firms who are relying on these optional exemptions are hereafter referred to as 'Article 3 firms'.

8.2 We are of the view, after discussions with the Commission, that 'analogous' does not mean 'identical to', and that an 'outcomes-based' approach would be acceptable, leaving us some discretion with respect to implementation.

8.3 In this chapter we identify where we need to make changes to our existing taping regime under COBS 11.8 to implement this new minimum framework for Article 3 firms and invite your views on how they may apply in practice as well as their potential impact.

Current regulatory framework

8.4 The FCA already applies a domestic regime for existing Article 3 firms, satisfying in practical terms the majority of the authorisation, supervision, conduct of business and organisational requirements specified under Article 3(2).

8.5 When the FSA implemented MiFID I in 2007 it chose to extend some of its requirements to non-MiFID II firms – including to Article 3 firms. For example, for non-MiFID II firms, the MiFID I organisational and systems and controls provisions apply; though, for the most part, the extension takes the form of guidance rather than rules. For the MiFID I conduct of business provisions, the application of the rules depends on the nature of the business undertaken by the firm.

26 Article 3(2) MiFID II: Member States' regimes shall submit the persons referred to in paragraph 1 to requirements which are at least analogous to the following requirements under this Directive: (a) conditions and procedures for authorisation and on-going supervision as established in Article 5(1) and (3), Articles 7 to 10, 21, 22 and 23 and the corresponding delegated acts adopted by the Commission in accordance with Article 89; (b) conduct of business obligations as established in Article 24(1), (3), (4), (5), (7) and (10), Article 25(2), (5) and (6), and, where the national regime allows those persons to appoint tied agents, Article 29, and the respective implementing measures; (c) organisational requirements as laid down in the first, sixth and seventh subparagraph of Article 16(3) and in Article 16(6) and (7) and the corresponding delegated acts adopted by the Commission in accordance with Article 89.

8.6 However, one of the new organisational requirements under MiFID II Article 16(7), the recording of telephone conversations or electronic communications of certain transactions and which is articulated in Article 16 (7) does not exist in our current domestic framework for those Article 3 firms that are retail IFAs and boutique corporate broking firms.[27]

8.7 Article 16(7) of MiFID II specifies the need to record certain telephone conversations and electronic communications, including, at least, transactions concluded when dealing on own account and the provision of client order services that relate to reception, transmission and execution of client orders, but also those conversations that are intended to result in a transaction.

8.8 On the basis that any domestic regime would need to achieve broadly the same outcomes as Article 16(7) and the future Level 2 implementing measures in terms of their investor protections aims[28] we are exploring and are keen to hear views on, whether to simply apply the full MiFID II Article 16(7) requirements and their corresponding implementing measures to Article 3 firms that fall within Article 3.1 (a) – (c).

8.9 From a consumer protection perspective, introducing such standards across all firms, may improve their behaviors when conducting business. It will also enable us to assess firms' compliance with the conduct of business requirements, pursue enforcement cases for market abuse and support claims of non-compliance with our regulatory requirements. All of these factors may act as a deterrent for firms that fail to act in their client's best interests. It may also facilitate quicker and easier dispute resolution between firms and clients over terms of transactions and the provision of the service.

8.10 Although market abuse in relation to retail financial advisers is unusual, there have been examples in the past where a recording requirement would have been useful, in detecting whether a retail financial adviser has been facilitating market abuse.

8.11 For corporate finance business, as the risk of market abuse is considered to be higher, we consider that recorded telephone evidence is of paramount importance. Corporate finance firms routinely have access to inside information and present an acknowledged risk of insider dealing and improper disclosure.

8.12 If we decide to apply the amended MiFID II framework to Article 3 firms, firms will need to take all reasonable steps to record relevant telephone conversations, face-to-face meetings and electronic communications relating to actual or proposed client transactions. The rule applies irrespective of the categorisation of the client concerned. Clients must be notified that telephone conversations will be recorded. Firms must also take reasonable steps to prevent employees from using personal devices that cannot be recorded. The records need to be kept for at least five years and provided to the client on request. Regulators may require firms to retain the records for a longer period.

8.13 If the Commission follows ESMA's advice, the Level 2 implementing measures will introduce additional organisational requirements such as: recording, in a durable medium, relevant information from face to face conversations that relate to the reception and transmission of

27 When we introduced this domestic recording regime, we created exemptions for certain firms; retail financial advisers and firms providing corporate finance (COBS 11.8.2R, 11.8.3R and 11.8.9G). However, Article 3 of MiFID II will require us to remove these exemptions for the reception and transmission of orders.

28 The deterrence of market abuse, to assist regulators in assessing firms' on-going compliance with the conduct of business obligations, in particular information to clients and potential clients and in relation to best execution and client-order handling and finally to ensure that there is evidence to resolve disputes between the firm and its clients over the terms of transactions and the provision of the service (Recital 57 MiFID II).

an order; monitoring records to ensure compliance with wider regulatory requirements; and recording relevant internal calls that relate to the transaction. Additionally, ESMA clarified that, while the provision of investment advice is not explicitly subject to the recording obligations, conversations and communications that result or may result in the reception, transmission and execution of client orders are subject to the rules, and this may include investment advice.

8.14 During our stakeholder engagement, we have widely heard that retail financial advisers and firms providing corporate finance business vary in terms of their commercial practices concerning record-keeping. For some smaller firms, this requirement will represent a significant change and concerns were raised in respect to the likely costs involved. We would be interested to hear views on likely costs both for the installation of recording solutions and retention costs.

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?

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

8b. The current recording rules for discretionary investment managers

When we introduced our domestic taping regime in 2009 we granted two exemptions to discretionary investment managers. A discretionary investment manager for these purposes is a person who acts on behalf of clients and manages designated investments in an account or portfolio on a discretionary basis under the terms of a discretionary management agreement.

8.15 The current rules do not require discretionary investment managers to record their conversations and electronic communications with:

1. other firms that are subject to the taping rules (since these should be captured through the obligations on those 'sell-side' firms)
2. firms that are not subject to the taping rules (such as overseas brokers) if such conversations and communications are infrequent and constitute only a small proportion of the total relevant conversations and communications made by a discretionary investment manager

Proposed changes to the recording rules for discretionary investment managers

8.16 We are aware that if the exemptions for discretionary investment managers are retained we will have inconsistent recording standards depending on the type of activities firms carry out. In this event, Article 3 firms are likely to be subject to more stringent requirements than discretionary investment managers as they will not have the option to take advantage of the above 'duplication exemption'. We are keen to avoid inconsistencies in our supervisory approach and would like to ensure a level playing field within the recording rules as this will provide clarity and consistency to firms when interpreting our rules.

8.17 In addition, the recording of conversations of discretionary investment managers will help us to detect and deter market abuse, assess firms' ongoing compliance with their conduct of business obligations, and ensure that there is evidence to resolve disputes between firms and their clients over the terms of a transaction.

8.18 For these reasons, we propose to remove the duplication exemption that currently applies in our domestic rules to discretionary investment managers and apply the organisational recording rules that are articulated in Article 16(7) of MiFID II.

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

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

9.
Costs and charges disclosures

9.1 MiFID II introduces a new costs and charges disclosure requirement. This requires firms to disclose all costs and charges associated with an investment service and financial instrument, which are not caused by the occurrence of underlying market risk, at the point of sale and, as appropriate, on an annual basis.

Technical challenges of implementing the costs and charges requirement

9.2 We recognise that there are a number of technical challenges in presenting aggregated costs and charges information to consumers. This is particularly true given that, in parallel to MiFID II which covers disclosure of costs and charges associated with both products and services, a separate pre-contractual disclosure is being developed as part of the PRIIPs Regulation. For UCITS, a Key Investor Information Document (KIID) also already exists, although this is ultimately due to be replaced by the PRIIPs Key Information Document (KID).

9.3 As highlighted in ESMA's technical advice to the Commission, it is important that there is consistency between the MiFID II costs and charges requirement, the PRIIPs Regulation and the UCITS Directive. This consistency is essential to avoid consumer confusion and ensure the burden placed on firms to provide this information is proportionate.

9.4 As an example, the UCITS KIID does not currently require firms to provide information about transaction costs. However, if the Commission adopts ESMA's MiFID II technical advice, firms will be required to include information about transaction costs in the MiFID II costs and charges disclosure. Separately, the FCA and DWP have published a call for evidence looking at the transparency of transaction costs. While this work focuses on transaction costs in the workplace pensions market, this may have relevance to wider efforts to increase the transparency of costs and charges for other retail investments.[29]

9.5 While some of these technical challenges are likely to be addressed by the Commission in the final implementing measures, we are aware that firms may still face some technical challenges to prepare the MiFID II costs and charges disclosure. We are keen to explore with firms the practical and technical challenges they may face, so these can be addressed to deliver a coherent MiFID II costs and charges disclosure regime.

> **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?**

29 *Transaction costs disclosure: improving transparency in workplace pensions*, DP15/2, 2015

Standardisation

9.6 MiFID II does not prescribe how information on costs and charges should be presented to consumers. Article 24(5) permits Member States to allow this information to be presented in a standardised format. Standardisation across the market would ensure that the information firms provide empowers consumers to make informed decisions about the investments and services they are looking to buy or already hold.

9.7 If we were to standardise any part of the MiFID II costs and charges disclosure, this would be subject to appropriate consumer testing. We would also draw on insights from behavioural economics to ensure the information presented to consumers delivered the intended outcomes. However, at this stage, we would welcome views on whether we should investigate standardising some, or all, of the MiFID II costs and charges disclosure.

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

10. MiFID II's revised inducements standards

10.1 MiFID II significantly strengthens existing MiFID I standards relating to the types of third party inducements firms can receive. This chapter sets out these new standards – affecting both advised and non-advised business, and our likely approach to implementation in the UK. It does not discuss the issue of the receipt of research as an inducement for portfolio managers or independent advisers, which as noted earlier was the subject of our recent publication FS15/1.

10.2 In some cases, MiFID II imposes requirements which are stricter than our own domestic regime. For example, it bans discretionary investment managers from accepting and retaining fees, commissions or any monetary or non-monetary benefits from third parties, apart from certain minor non-monetary benefits. We also anticipate, once finalised, MiFID II's rules for independent advisers will tighten standards domestically.

10.3 It is also likely to tighten standards for all other investment firms, with the implementing measures likely to prescribe criteria to be satisfied for the 'quality enhancement' test to be met.

10.4 Firms should be aware of the scope and nature of these rules, which apply to all MiFID II business, and as a consequence apply widely to a variety of services, activities and products (for further information please see Annex I of MiFID II, which details the scope).

10.5 Domestically, we have extended the scope of the MiFID I inducements standards to insurance-based investments and pensions. In this chapter we also consider the extent to which we should maintain this consistency.

Inducements rules for independent advisers and discretionary investment managers

10.6 For both independent advisers and portfolio managers, MiFID II's provisions ban the receipt and retention of all monetary benefits and also all non-monetary benefits from third parties, other than 'minor non-monetary benefits'. At present, under COBS 6, all advisers (both independent and restricted) can only be remunerated for advice by adviser charges.

10.7 The Commission may introduce an exhaustive list of acceptable 'minor non-monetary benefits' within the implementing measures. Based on ESMA's advice to the Commission, acceptable benefits may be restricted to generic information relating to a product or service, participation in conferences, seminars and other training events on the benefits of a particular product or service, and hospitality of a reasonable de minimis value (such as food and drink during a business meeting).

10.8 We published guidance in January 2014 following a review of whether advisory firms were soliciting payments for entering into service or distribution agreements that could lead them to channel business to particular providers and affect the advice given to clients, or whether providers were offering these payments to secure distribution of their products. We anticipate, once finalised, MiFID II's rules for independent advisers will tighten standards domestically.

10.9 Both our adviser charging and inducements rules currently apply to all adviser firms – those providing restricted advice as well as those providing independent advice. We believe it is appropriate to copy across the likely more restrictive inducements regime to firms providing restricted advice. We consider that it would cause confusion and permit firms to undermine the RDR adviser charging rules if we allowed restricted firms greater flexibility than independent firms over the payments or benefits they can accept from providers and other third parties.

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?

10.10 MiFID II applies the same ban to discretionary investment managers, so these firms will also be banned from accepting and retaining any third party inducements, other than minor non-monetary benefits. Discretionary investment managers are currently only subject to the more general inducements rules,[30] so they can receive payments from providers and other third parties if these do not impair compliance with the firm's duty to act in the best interests of the client and are designed to enhance the quality of the service to the client. So the new ban on payments and other non-monetary benefits may have a significant impact on these firms. As we discuss in Chapter 4, MiFID II allows third party inducements to be accepted if they are rebated back to the client, and we are seeking views on whether to introduce additional rules to prevent this.

10.11 MiFID II's inducements rules apply to both retail and professional clients. This ban on payments will therefore also apply to business conducted for professional clients, in contrast to our existing RDR commission ban, which only applies to retail clients.

Inducements rules for firms carrying out other activities

10.12 Other types of firms, including those that arrange the sale of MiFID II investment products but do not provide advice, will remain subject to the more general inducements provisions.

10.13 MiFID I introduced three specific requirements, each of which must be satisfied in relation to the acceptance of third party inducements. These are i) where the inducement can be shown to 'enhance the quality of the relevant service to the client' (the 'quality enhancement' test), ii) where it can be shown not to impair compliance with the firm's duty to act honestly, fairly and professionally in accordance with the client's best interests, and iii) where it is disclosed to the client.

10.14 MiFID II aims to strengthen these, promoting them from the existing MiFID I implementing measures to MiFID II Directive. We anticipate criteria in the implementing measures to set out how firms can demonstrate that an inducement meets the 'quality enhancement' test. If ESMA's technical advice is adopted by the Commission, the implementing measures will include

30 The general inducements rules are also amplified by requirements in COBS 11.6 on investment managers' use of dealing commissions – the fees paid to brokers to carry out trades in equities or equity-related derivatives on behalf of their customers. We viewed these as consistent with the original MiFID II inducements rules when we implemented MiFID I, although we notified the Commission on a precautionary basis under Article 4 of MiFID I Level 2. We discussed the implications of MiFID II for our use of dealing commission regime in FS15/1.

a non-exhaustive list of circumstances in which an inducement will be deemed not to meet the quality enhancement test. This may include cases where:

- the inducement is not justified by the provision of an additional or higher level of service, such as access to a wide range of suitable products, including an 'appropriate' number of investments from providers that do not have close links with the firm; and/or
- the inducement directly benefits the firm, its shareholders or employees without any tangible benefit to the relevant client; and/or
- in the case of an ongoing inducement, it is not justified by the provision of an ongoing benefit to the relevant client.

Inducements standards for insurance-based investments and pension products

10.15 For the reasons outlined in Chapter 2, we applied the MiFID I inducement rules to the sale of insurance-based investments and pension products.

10.16 The extent to which IDD will include inducement rules for insurance-based investments that replicate MiFID II's obligations is currently unclear. To ensure strong, clear and consistent standards for the sale of substitutable products and to minimise the risk of regulatory arbitrage, we believe it is appropriate to continue to preserve consistency between the sale of MiFID II products and insurance-based investments and pensions for both advised and non-advised business.

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.

11. Complex and non-complex products and application of the appropriateness test

Existing requirements

11.1 MiFID I introduced a distinction between products deemed either 'non-complex' or 'complex' for product sales that are not made through a personal recommendation or provided by a portfolio management service.

11.2 This categorisation is not typically aimed at consumers but is used by firms to determine whether they need to conduct an appropriateness test when distributing a particular product without advice.

11.3 An appropriateness test is a test by the firm to understand the knowledge and experience of the client to enable it to assess whether a particular product or service is appropriate for the client. Our current domestic requirements around the appropriateness test can be found in Chapter 10 of our COBS sourcebook.

11.4 The appropriateness test applies to all complex products, so products deemed complex cannot be sold execution-only. They are also unlikely to be sold through any direct offer financial promotion, as it is difficult to see how an individual assessment of necessary knowledge and experience of the customer could be undertaken.

Potential future requirements

11.5 In a deliberate attempt to increase investor protection, MiFID II has restricted the types of products that are classified as 'non-complex' (as set out in Article 25(4) of the Directive). MiFID II introduces new complexity criteria for debt securities, which will be considered complex if they have a 'structure which makes it difficult for clients to understand the risks involved'. It also introduces criteria for structured deposits, so that products with a structure that makes it difficult for a client to understand the risk of return, or understand the cost of exiting before term, will automatically be considered complex.

11.6 We understand the Commission is taking a strict interpretation of these criteria, with any products excluded from the criteria for 'non-complex' within Article 25(4) being considered complex. In future, it is likely that any shares and bonds that embed a derivative, structured UCITS, non-UCITS collective investment undertakings (sometimes known as 'NURSs' in the UK) and even some structured deposits, will be considered complex.

11.7 This is likely to significantly reduce the types of products that can be considered 'non-complex', with few instruments other than plain vanilla shares and bonds, (non-structured) UCITS funds and structured deposits meeting particular criteria being able to be sold in the retail market without an appropriateness test. ESMA has been asked to develop guidelines to help firms determine when a product is deemed complex, which are due to be published in January 2016.

Our approach

11.8 We understand domestic concerns that this is likely to make non-UCITS collective funds 'complex products', while (often) similar non-structured UCITS may be 'non-complex'. We therefore want to highlight this issue now with firms, clearly setting out our expectation that the types of products that are considered 'non-complex' will be significantly limited. Of particular relevance to the UK, non-UCITS collective investment schemes (such as NURSs) are likely to be considered complex, and therefore subject to the appropriateness test.

11.9 Assessing whether a potential customer has the knowledge and experience needed to understand the risks of a complex product is an important aspect of ensuring an appropriate consumer protection regime. Firms will need to make appropriate assessments of a client's knowledge and experience before selling any complex products.

11.10 We also want to take this opportunity to suggest how firms may be able to apply the appropriateness test to particular types of financial products. Not all 'complex' products come with the same risks, and do not require the same level of knowledge and experience.

11.11 Some complex products have exotic underlyings, a significant degree of leverage increasing the risks for the average investor, or come with complicated penalties for exiting early. Other complex products may be more straightforward – perhaps they are complex because they embed a single derivative that is relatively straightforward for the potential investor to understand, or they comprise a NURS with more 'vanilla' underlying funds or assets. We would expect the appropriateness assessment to be particularly rigorous if a firm was offering more complex financial instruments to less experienced customers who may be less likely to understand the risks.

11.12 Firms will want to consider the requirements of the appropriateness test, and consider the sorts of knowledge and experience that may be appropriate for a firm to capture and assess when selling certain products. Our existing rules in COBS 10 provide guidance for firms on how they can ensure that they are meeting our requirements to assess the knowledge and experience of their customers. Our rules indicate what information may be relevant. This includes: i) the types of services and financial instruments with which the customer is familiar; ii) the nature, volume and frequency of the customer's previous transactions; iii) the customer's level of education; and iv) the customer's profession or former profession. We also explored this in our recent guidance on the boundaries of investment advice.[31]

11.13 Firms that currently offer direct offer financial promotions may be particularly impacted by MiFID II's changes in this area. It is unlikely that a firm offering products through a direct offer will be able to meet the requirements of the appropriateness test. This is because the obligation to perform the appropriateness test is on the firm, not the client, or potential client. This may have a particular impact on firms distributing non-UCITS collective investment schemes in the UK.

31 *Retail investment advice: clarifying the boundaries and exploring the barriers to market development*, FG15/1, FCA, 2015

11.14 Firms may also want to consider the impact on their online distribution models. Firms may want to develop a way of collecting relevant information from consumers to allow them to assess whether they have the knowledge and experience to understand the risks of a particular product. We would expect this to be proportionate in relation to the complexity of the particular product. We would emphasise that simply collecting this information is insufficient in itself – firms are required to make an assessment of the client's knowledge and experience before a particular type of product can be sold.

Annex 1
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.**

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.**

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?**

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?**

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?**

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

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

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

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?**

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.**

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

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

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.**

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

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

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

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

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?**

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

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

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

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?**

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

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?**

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.**

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