Regulator Assessment: Qualifying Regulatory Provisions

Title of proposal: Extension of certain MiFID II inducement provisions to firms providing investment advice and portfolio management to retail clients

Lead regulator: FCA

Date of assessment: 23 March 2018

Commencement date: 3 January 2018

Origin: Domestic extension of EU legislation

Does this include implementation of a Cutting Red Tape review? No

Which areas of the UK will be affected? Whole of the UK

Brief outline of proposed new or amended regulatory activity

In 2006, the Financial Services Authority (the FSA), the predecessor body of the FCA, launched the Retail Distribution Review (RDR) with the aim of making the retail investment market in the UK work better for consumers. The RDR identified various long-running problems that were affecting the quality of advice and consumer outcomes, as well as confidence and trust, in the market.

Following the RDR, the FSA introduced various new requirements ("RDR rules") for firms providing investment advice to UK-based retail clients on retail investment products (RIPs). These RDR rules applied regardless of the type of advice being provided (i.e. whether independent or restricted).

MiFID II brought in new inducement requirements for advisers and portfolio managers (in Article 24(7) (b) and 24(8)). These are similar to our RDR rules but they also differ in a number of regards, as follows (please also refer to the table below for information):

- MiFID II's Article 24(7)(b) and 24(8) apply to firms providing advice or portfolio management services to all retail and professional clients – our RDR inducement rules only apply to firms providing advice to UK-based retail clients;
- MiFID II's Article 24(7)(b) applies only to independent advice – our RDR inducement rules apply to both independent and restricted advice;
- MiFID II applies to MiFID financial instruments – our RDR inducement rules only apply to RIPs[1];

[1] RIPs and MiFID financial instruments both have very broad scope, and in general terms they refer to different types of product or instrument. However, they also overlap. The main area of overlap is in relation to units and certain types of structured product, which may be considered both a RIP and a MiFID financial instrument.

- MiFID II's Article 24(7)(b) and 24(8) ban advisers / portfolio managers from accepting inducements, unless they pass the inducement on to the client – our RDR inducement rules ban <u>an adviser</u> from accepting any inducement irrespective of whether the adviser passes this on to the client.

	UK RDR Rules	**Article 24(7)(b) MiFID II**	**Article 24(8) MiFID II**
Application - service	Personal recommendations made on an **independent *or* restricted** basis in relation to retail investment products	Personal recommendations made on **an independent basis only,** in relation to MiFID financial instruments	Portfolio management where the portfolio includes one or more MiFID financial instruments
Application – clients	Retail clients in the UK only	Retail and professional clients	Retail and professional clients
Application – products	Retail Investment Products (RIPs)	MiFID financial instruments	MiFID financial instruments
Nature of restriction	Firm must **not <u>accept</u> inducements**.	Firms must **not <u>retain</u> inducements**, i.e. firms may accept inducements providing they pass the inducement on to the client.	Firms must **not <u>retain</u> inducements**, i.e. Firms may accept inducements providing they pass the inducement on to the client.

In implementing MiFID II, we wanted to retain our existing RDR rules, and also create a consistent inducement regime for firms providing advice and portfolio management services to UK-based retail clients on both RIPs and MiFID financial instruments. Therefore, for firms providing financial advice and portfolio management services to UK-based retail clients, we transposed MiFID Articles 24(7) (b) and 24(8) in such a way as to broadly mirror the scope of application of the UK's existing RDR rules. This means that we have chosen to extend the MiFID II inducement provisions in the following ways:

a. Apply the inducement ban in Article 24(7) (b) not only to firms providing advice on an independent basis (as in MiFID II), but also to those providing advice on a restricted basis, where the advice is given to UK-based retail clients. **This mirrored what was already in place under RDR (albeit that the RDR rules only applied to RIPs, not MiFID financial instruments)**.

b. For firms providing financial advice or portfolio management services to UK-based retail clients, apply the inducement bans in Articles 24(7) (b) and 24(8) not only to the retention of inducements (as in MIFID II) but to the initial acceptance of inducements (i.e., to ensure that firms cannot accept inducements even if they intend to pass them on to the client). Again, for advisers, this mirrored what was already in place under RDR; **for Portfolio Managers, this was a new requirement**.

At the same time as we implemented MiFID II, we clarified an aspect of our RDR rules. Before 3 January 2018, our RDR rules banned a firm providing advice to UK-based retail clients on RIPs from accepting any commission, remuneration or benefit *in connection with a personal recommendation* (e.g. firms were not allowed to receive commission in return for recommending a specific product to a client). The clarification of the RDR rules on 3 January 2018 means that a firm providing advice to UK-based retail clients on RIPs is now banned from accepting any commission, remuneration or benefit in connection *with their wider advice business*.[2]

This clarification only applied to firms providing advice to UK-based retail clients on RIPs. So, because we wanted to create a consistent inducement regime for firms providing advice to UK-based retail clients on both RIPs *and* MiFID financial instruments, we had to also apply MiFID II in such a way that it mirrored our clarified RDR rules. This meant that for firms advising UK-based retail clients on MiFID financial instruments, we implemented MiFID II's inducement rules so that they also applied to the whole of a firm's advice business (which our RDR rules now do too, and which goes beyond the text of MiFID II). This is therefore a new requirement for all firms providing advice on MiFID products (including those which are RIPs).

The practical effect of these changes is as follows:

- Our extension of the inducement ban in Article 24(7) (b) to firms providing advice on a restricted basis mirrors the existing RDR rules. Restricted advisers will already have been subject to RDR, so this extension of MiFID II will only bring in new requirements where these firms providing restricted advice on MiFID financial instruments which are not RIPs.

- Our extension of the inducement ban in Article 24(7) (b) and 24(8) so that it prevents the initial acceptance of inducements also mirrors the existing RDR rules. For advisers therefore, the extension of MiFID II will only bring in new requirements where firms provide advice on MiFID financial instruments which are not RIPs. However, **firms providing portfolio management services (to UK-based retail clients) will not have been subject to RDR rules. This extension to MiFID II therefore brings in new requirements for these firms**.

- Our extension of the inducements ban so that it bans advisers from accepting commission, remuneration or benefit in connection *with their wider advice business* is a new requirement. It applies to all firms providing advice on MiFID financial instruments including those which are also RIPs.

For firms providing independent investment advice and portfolio management services to **professional clients** or to **retail clients not based in the UK**, we directly transposed the requirements in MiFID Articles 24(7) (b) and 24(8) without any extension.

Which type of business will be affected? How many are estimated to be affected?

[2] The inducement ban relating to the 'wider business of advice' reaches further and is more restrictive than the inducement ban relating to the provision of a personal recommendation only. The ban relating to the 'wider business of advice' prevents advisers from accepting payments which may not necessarily be related to a specific personal recommendation, but which nevertheless may conflict with an adviser's obligation to act in their client's best interest. For example, if a retail investment product provider makes any payment, or other material inducement, to an adviser (which sells the product provider's products), then the adviser may be incentivised to advise their clients in general to invest in that product provider's products. The payment itself does not relate to any specific personal recommendation (rather it relates to the adviser's broader business of advising), but it may conflict with the adviser's obligation to the client. An adviser is no longer able to accept any such payment.

Firms affected are those providing financial advice or portfolio management services to retail clients on MiFID financial instruments.

By searching the FCA register, we obtained an estimate of 16,854 affected firms. This captures all firms with permissions for 'advising on investments' and 'managing investments' as it is these activities to which the inducement rules apply. However, this will also capture a population of firms who do not provide services to retail clients based in the UK (e.g. retail investors based outside of the UK, or professional investors). For these firms we have transposed pure MiFID II rules (i.e. we did not implement additional requirements). With the data to which we have access it is not possible to capture only those firms which provide services to retail customers in the UK. Therefore, the number provided above is a conservative figure, and may be an overestimate.

Price base year	**Implementation date**	**Duration of policy (years)**	**Business Net Present Value**	**Net cost to business (EANDCB)**	**BIT score**
2016	3 January 2018	10 years	-4.6	0.5	2.6

Please set out the impact to business clearly with a breakdown of costs and benefits

In order to inform our cost-benefit analysis (CBA) for MiFID II implementation consultation purposes, in September 2015 we surveyed approximately 5,000 FCA authorised firms, asking for data to support our consultation proposals. We consulted on our proposals in a series of consultations during 2016 and 2017, seeking feedback on the proposals and the accompanying CBA.

Our analysis of costs and benefits for extending the MiFID II independence provisions to firms providing advice to retail clients on non-MiFID business/products is set out on pages 137-142 of Annex 2 (Cost benefit analysis) of CP16/29 (see full reference, and link to CP, below), finalised in PS17/14. In addition, for this impact assessment, we have calculated the relevant familiarisation and gap analysis costs.

Familiarisation & gap analysis costs

We expect the impacted firms to read the relevant changes in order to familiarise themselves with the detailed requirements of the new rules and guidance. We also expect impacted firms to perform a gap analysis to check their current practices against these expectations.

Based on assumptions on the time required to undertake this analysis, and the cost of this time to firms, we estimate that firms will incur an average cost of £**279**[3] each to undertake this work. In aggregate, this indicates an overall cost of £**4.7** million.[4]

Implementation costs

[3] The assumptions used to estimate these costs have been derived from a research project on compliance costs that involved consultation with firms and trade bodies, discussions with vendors, a review of previous CBAs, internal FCA consultation, and desk-based research. To put a cost on time, we have sourced salary information for a range of occupations in financial services. Figures for large and medium firms are based on the 2016 Willis Towers Watson UK Financial Services Report. Small firm salaries were sourced from a systematic review of adverts on the website of Reed, cross-referenced with other publicly available sources. We add an allowance for overheads of 30% to all time costs to account for non-wage labour costs, as advocated by the HM Treasury Green Book.

[4] This aggregate cost figure is likely to represent an upper bound estimate given the potential overestimation of the number of firms impacted.

Broadly, we consider that our implementation of MiFID II inducement rules mirror, in large part, our pre-existing RDR rules (which applied to firms providing financial advice to UK-based retail clients on RIPs). This means that the new MiFID requirements result in no material implementation costs beyond familiarisation and gap analysis with regards to MiFID financial instruments which are now in scope. Where there are differences with existing rules (e.g. applying further rules to discretionary portfolio managers which are not captured by the RDR rules), we believe that there will be no significant cost impacts for these firms.

In addition to this, we do not believe that our rules preventing firms from paying, accepting or retaining commission (where, under the core MiFID II text, many firms would have had to pass the commission on to their client) can have any net cost impact on the market as a whole.

The following section outlines the basis for this judgement for the discretionary proposals described previously.

Our decision to apply the inducement ban in Article 24(7) (b) to firms providing advice on both an independent and a restricted basis:

We consider that it is appropriate to apply MiFID's inducement ban to both independent and restricted advice. Our pre-existing rules already substantially met the MiFID II standards (albeit not for MiFID financial instruments). As such we do not believe impacted firms will face any significant costs, beyond familiarisation and gap analysis, given compliance with the rules which were previously in place.

Our decision to apply the inducement bans in Articles 24(7) (b) and 24(8) not only to the retention of inducements but to the initial acceptance of inducements (i.e., to ensure that firms cannot accept inducements even if they intend to pass them on to the client):

As above, for firms providing advice to UK-based retail clients on RIPs, our pre-existing rules already substantially met the MiFID II standards (albeit not for MiFID financial instruments). Similarly therefore, these firms will only incur familiarisation and gap analysis costs.

Portfolio managers dealing with retail clients were outside of scope of our RDR rules. Therefore, our implementation of MiFID II would have brought in new rules for these firms. However, our CBA survey indicated that 95% of respondents do not accept and rebate third party payments.

We therefore do not believe that there will be additional remediation costs for firms in implementing our proposal.

More broadly, respondents also confirmed that they do not distinguish between MiFID-scope products and non-MiFID RIPs. We therefore do not expect our proposal to extend the ban in relation to MiFID-scope instruments to carry additional costs. Further, none of the respondents that accept inducements indicated that there would be any negative impact from not being able to continue to do so, including on their operating costs, number of clients or choice of funds.

Our decision to apply the inducement ban in Article 24(7) (b) not only to the provision of investment advice, but to the whole of a firm's advice business:

The decision to implement MiFID II in this way represents a clarification of our expectations of how firms should comply with RDR inducement rules following implementation in 2012; it does not represent new rules (albeit that the existing rules do not apply to MiFID financial instruments). Again, therefore, firms subject to these new rules will only incur familiarisation and gap analysis costs.

The changes proposed to extend certain MiFID II inducement provisions to firms providing investment advice and portfolio management services to retail clients are expected to benefit consumers. For example, consumers should benefit because inducements do not weaken the firm's incentive to act in the best interests of their clients. The benefits to consumers and society are likely to exceed the cost to firms. However, under the Act, benefits to consumer and society are out of scope for impact assessments. These are considered in our CBA prior to rule changes.

Please provide any additional information (if required) that may assist the RPC to validate the BIT Score.

We consulted on these requirements in:

- March 2015, FCA Discussion Paper DP15/3: "Developing our approach to implementing MiFID II conduct of business and organisational requirements" - in particular, pages 41-43 (3 pages) of Chapter 10: https://www.fca.org.uk/publication/discussion/dp15-03.pdf
- September 2016, FCA Consultation Paper CP16/29: "Markets in Financial Instruments Directive II Implementation – Consultation Paper III" – in particular, pages 15-23 (9 pages) of Chapter 2 (CP proposals); pages 137-142 of the CBA Annex (6 pages); and pages 57-67 of the draft Rules Instrument (11 pages): https://www.fca.org.uk/publication/consultation/cp16-29.pdf

Our final feedback on these requirements, and final rules, are set out in FCA Policy Statement PS17/14: "Markets in Financial Instruments Directive II Implementation – Policy Statement II" (July 2017) – in particular, pages 38-47 (10 pages) of Chapter 6 (CP feedback); and pages 52-63 of the final Rules Instrument (12 pages): https://www.fca.org.uk/publication/policy/ps17-14.pdf