

FSA's consultation on 'Distribution of retail investments: Delivery the RDR'

Submission from The Association of Investment Companies

The AIC is the trade body representing some 350 closed-ended investment companies with £67 billion of assets under management. On average, retail investors own around half of the sector, although in some sub-sectors, for example venture capital trusts, this may rise to 100%. The distribution arrangements for retail investment products and services are a key area of interest for our Members. The AIC supports proposals to improve the quality of the provision of investment advice.

The AIC particularly welcomes proposals to extend the scope of 'retail investment products' to incorporate investment trusts. This should mean that investors taking advice are in a better position to consider the sector and to make comparisons (on the basis of cost and investment options) with open-ended products. However, it is **recommended** that the broader term 'investment company' is used instead of 'investment trust'. The investment company sector incorporates vehicles with similar characteristics to investment trusts but which offer exposure to a wider range of asset classes (see question 1). Retail investors obtaining independent advice would then benefit from analysis of a wider spectrum of potentially suitable investment opportunities.

Other key **recommendations** are that:

- guidance is provided on the meaning of key terms used to define independent advice, namely "*comprehensive and fair analysis*" and "*unbiased and unrestricted advice*";
- each firm should produce its own statement describing the breadth of its advice service which is used consistently to inform clients and potential clients of the service it provides;
- a firm's statement of the breadth of its advice service should be disclosed in a prominent place on its website;
- descriptions for restricted advice should explain why the service is restricted and the effect that this has on the service provided;
- additional obligations should be imposed on vertically-integrated firms to improve transparency;
- the Code of Ethics forms part of the FSA Handbook.

Detailed comments

Q1: Do you agree with our proposal to widen the range of products to which the new independence standard will apply?

The AIC **agrees** that the new independence standard should apply to a broader range of products.

Part (f) of the proposed definition of 'retail investment product' includes a specific reference to "*a security in an investment trust*". This change is welcome as it will encourage advisers who wish to meet the independence standard to consider the investment trust sector when giving independent advice. This will provide investors with better quality investment advice as the investment decision will be based on broader research.

However, the AIC **recommends** that part (f) of the definition of retail investment product is expanded to encapsulate all investment companies listed on the UK market. The term investment company, which includes, for example venture capital trusts, comprises vehicles with similar characteristics to investment trusts and which apply the same principles in terms of spreading investment risk, disclosing investment policies and providing tax transparency. However, whereas investment trusts typically only invest in equity securities, the wider investment company sector offers exposure to a broader range of asset classes, including property and private equity.

Investment companies listed on the UK market are subject to high standards of regulation. For example, they must publish and follow an investment policy, provide an annual statement on the continuing appointment of the manager, adhere to detailed financial reporting rules including publishing annual accounts, half-yearly accounts and interim management statements, meet liquidity requirements and obtain shareholder approval for the appointment and re-appointment of directors.

By including investment companies in the definition of 'retail investment product', private investors seeking independent advice would benefit from consideration of a wider spectrum of suitable investment opportunities. This approach is in line with the European Commission's view that the same rules should apply to products with broadly comparable functions for retail investors.

Q2: Do you agree with our proposals for a new standard for independence that requires firms providing independent advice to make recommendations based on a comprehensive and fair analysis of the relevant market, and to provide unbiased and unrestricted advice?

The new standard for independence should set a high quality benchmark and provide retail investors which access to comprehensive and properly researched advice. In conjunction with proposals for the new charging structure, it should also help to reduce the risk that advice is influenced by conflicts of interest. However, access to independent advice will partly depend on the number of advisers which elect to follow this route.

The insertion of the word 'relevant' in "*comprehensive and fair analysis of the relevant market*" will enable firms to remain commercially flexible by offering a specialist service focussing on a niche area of the market. The disclosures required by 6.2A.6(2) will ensure that clients are fully aware of the scope of the firm's service.

The requirement for independent advice to be based on a “*comprehensive and fair analysis*” may need further explanation. For example, it may be helpful to provide guidance or examples on the meaning of ‘comprehensive’, ‘fair’ and ‘analysis’ to ensure consistency in the quality of services provided.

The same point applies to the term “*unbiased and unrestricted advice*”. Guidance may be useful to ensure that the terms ‘unbiased’ and ‘unrestricted’ are subject to a common interpretation. For example, ‘unbiased’ should be taken to mean that investment recommendations are driven by the needs of the client and their attitude to risk and not influenced by personal or financial connections, family links or financial incentives, including for example, situations where the product provider has a financial interest in the adviser firm and the payment of soft commission. The criteria for ‘unrestricted’ might include not being subject to any limitations on the scope of the advice imposed by the product provider.

It is also **recommended** that guidance is provided on the implications of applying these new standards on the creation and application of best buy tables.

Q3: Do you agree with our proposals for new disclosure requirements for firms?

In general, the AIC **agrees** with the new disclosures proposed for firms. However, it **recommends** that the rules require each firm to produce its own statement which is used in all cases where written disclosure of the breadth of the advice service is provided, including, for example, marketing material, client contacts, displays in the office and disclosure on website etc. This will ensure that a clear and consistent message is provided on all written communications.

The AIC also **recommends** that it is mandatory to disclose this standard wording in a prominent place on the company’s website (website disclosure is proposed as only one of two options for communicating the breadth of a firm’s advice service under 6.2A.7) as it is increasingly common for investors to use electronic resources when searching for an investment adviser.

Q4: Do you think we should introduce a mandatory form of words for firms to use when explaining restricted advice? What might this look like?

The AIC **agrees** that it is not necessary to introduce a mandatory form of words for written disclosure of restricted advice. However, in line with the recommendation in question 3, each firm should devise its own wording to be used consistency throughout its written communications. This standard wording should include the term ‘restricted’ in order to describe the fact that the service offering is restricted in some way and to reinforce the two-tier structure. The term ‘restricted’ should be specifically defined i.e. the way in which that firm’s services are restricted should be set out. This approach

should give adviser firms flexibility to formulate their own wording which most appropriately reflects their commercial offering

The inclusion of standard wording within the rules for the oral disclosure of restricted advice is too rigid and the AIC **recommends** that, within certain boundaries, adviser firms are able to produce their own wording which must be used consistency in all cases where verbal disclosure is given. The two options for standard wording set out in 6.2A.9, rather than being mandatory, should be used as a basis for examples of wording which a firm could adopt (but see next paragraph). This approach would give adviser firms more flexibility to tailor their own wording specifically to their particular service offering.

The AIC also **recommends** that both written and oral descriptions for restricted advice should explain why the service is restricted and the effect that this has on the service provided. For example, the explanation might state that the advice is restricted because it only considers products from a particular provider which is the adviser firm's parent company and that, as a result, the adviser may not consider alternative products which may provide a more appropriate investment outcome for its clients.

Q5: What are your views on removing this GPP exemption?

The AIC has no comment to make on this issue.

Q6: Do you agree that we should not create a new regime for simplified advice processes, but continue to work as needed with firms and the industry?

The AIC **agrees** that the FSA does not need to create a new regime for simplified advice processes, but should continue to work with the industry to identify appropriate regulatory improvements.

Q7: Do you agree that the professional standards set out in Chapter 5 should also apply to simplified advice processes?

Yes. This will help to raise standards across the industry and not distract from the simplicity of the new two-tier regime.

Q8: Do you agree that we should retain Basic Advice, and require those offering Basic Advice to disclose that they are providing restricted advice?

Yes.

Q9: Do you agree with our proposals on Adviser Charging for firms that give advice?

The AIC **agrees** with the abolition of the commission structure which allows product providers to secure distribution of their own products by providing financial incentives to the adviser network.

The AIC also **agrees** that adviser firms should be responsible for setting their own charging structure for both independent and restricted advice and that this should be based on the service provided; and not determined by who the product provider is or the product being recommended. This framework should remove the risk that the quality of investment advice is distorted by conflicts of interest and will improve the reputation of the sector.

The proposed charging structure should provide adviser firms with sufficient flexibility to agree the most appropriate basis for their charges (e.g. hourly rate, fixed charge, percentage of funds invested etc) and set commercially attractive rates. Consumers will have a clear choice between selecting independent or restricted advice and will be able to select a firm with a pricing structure which best suits their particular needs.

The AIC has some reservations about provision 6.1A.20 which prevents an adviser charge from being paid over a period of time unless it relates to an ongoing service or where regular investment contributions are made. There should be no question that this could restrict the staged payment of a large upfront one-off fee.

The AIC is also concerned about how rule 6.1A.21(2)(a) will work in relation to investment trusts (and investment companies generally if the scope of the definition of 'retail investment product' is expanded as recommended in question 1 above). Rule 6.1A.21(2)(a) requires the adviser firm to disclose the total adviser charge payable in cash terms. Investment trusts are traded on a regulated market and as such their share price can fluctuate constantly. Where the adviser charge is determined on the basis of the market value of the transaction, it would be impossible to calculate the precise fee in cash terms before the transaction takes place because of share price movements between the calculation date and the transaction date. Any fee calculated in advance of the transaction would be wrong, and in some circumstances materially, for example in volatile markets.

Q10: Do you agree with our proposals on Adviser Charging for product providers?

To ensure that the proposed charging structure for advisers works effectively and remains free of conflict, it is sensible to also introduce regulatory standards for product providers. The AIC therefore **agrees** that there should be a corresponding prohibition on product providers offering or paying commissions, remuneration or benefits in relation to an investment recommendation.

We accept that, for administrative purposes, product providers will continue to be able to facilitate the collection of adviser charges. The rules create some safeguards, for example 6.1A.13 will ensure that the adviser firm does not

allow the availability or limitations of services offered by third parties to inappropriately influence its charging structure or adviser charges. Provision 6.1B.11 will ensure that the product provider considers whether it offers sufficient flexibility in terms of the adviser charges it offers to administer so as not to “*unduly influence or restrict the charging structure and adviser charges*”. However, the question remains whether there may still be scope for the product provider, through the functioning of the administrative systems, to indirectly, and possibly unintentionally, influence the charging structure of the adviser. For example, the product provider may set limitations in terms of the minimum value of each transaction which it will administer or a maximum and/or minimum percentage rate which it will deduct from the payments it receives.

One solution to this issue is to eliminate the opportunity for manipulation to prevent product providers from offering administrative services to providers. However, this may not be appropriate for commercial reasons.

We are concerned that the meaning of the word ‘unduly’ in 6.1B.11 may be open to interpretation. On this point, we **recommend** that the word ‘unduly’ is removed from provision 6.1B.11 and replaced with wording along the lines of “*in a way which disadvantages the client*”.

Also, we query the appropriateness of rule 6.1B9(2). It says that product providers facilitating the administration of adviser charges must “*monitor the effect on the firm’s retail investment product of levels of adviser charges*”. The guidance in 6.1B.10 quotes an example of the product provider carrying out stress testing to ascertain whether the product can continue to perform as it is designed to if particularly high levels of adviser charges are deducted from it. The consultation paper identifies a need for product providers to be able to decline, or at least alert the FSA to, requests from adviser firms for payment of extreme adviser charges. It also acknowledges that monitoring responsibilities should be conducted by the product providers “*without undermining the need for adviser firms to be accountable for their own charges*”.

The AIC is concerned that, in practice, this creates competing objectives for product providers. If they are given responsibility for assessing whether the advisers’ charges are excessively high so that they reduce the benefits of purchasing the product, then they may still retain an element of influence over the adviser fee levels. Knowing that the product provider could refuse to provide an administrative function for a particular adviser, or even the threat that the product provider could report the adviser to the FSA, creates distortions to what is promoted as an independent service. In addition, it may be difficult for product providers to make an accurate assessment about whether adviser charges are ‘high’ without the full details of the service which the client is paying for. Also, who is responsible from a regulatory standpoint if a product fails to meet its investment objectives because of the erosion of returns – the provider or the adviser?

Q11: Do you agree with our proposals on Adviser Charging for vertically-integrated firms?

The AIC **agrees** that, as a minimum, the same standards for adviser charging should be applied to vertically-integrated firms. However, with vertically-integrated firms the risk that advice is influenced by conflicts of interest is higher, and it is questionable whether the nature of the relationship in certain circumstances truly enables independent advice to be given. Additional obligations should therefore be imposed on vertically-integrated firms. It is **recommended** that disclosures in relation to the breadth of the advice service include a description of the relationship with the vertically-integrated product provider. It is also **recommended** that vertically-integrated firms which apply the independence standard are required to make an annual statement of the percentage of their business which relates to their own products, along with an explanation for this figure. This statement should be made to the FSA, and possibility made public, e.g. through publication on the company's website.

Q12: Do you agree with our proposals on the disclosure of adviser charges?

The AIC **agrees** that adviser firms should provide a standard price list or tariff to their clients in writing and to present clients with a schedule showing the total of the adviser charges they are required to pay for the service they have selected. It is also sensible to require advisers to highlight any material differences between the standard and actual charges, although guidance may be helpful on the interpretation of 'material'.

Clearer disclosure of adviser charges will give clients greater certainty about how much they must pay and the precise nature of the service they are paying for. Improved transparency will make it easier for consumers to compare the cost of using alternative adviser firms, potentially leading to increased price competition in the sector. In the longer term, this may result in a general fall in charges as advisers compete more directly for business, which will benefit investors. Minimum professional standards should ensure that lower prices do not lead to a fall in the quality of advice provided.

Q13: What approach should we take to the remuneration of individuals giving investment advice?

The AIC has no specific suggestions on the remuneration of individuals giving investment advice. However, any remuneration policy should be based on performance indicators which seek to measure whether an individual has given appropriate investment advice during the period under review. Any system should seek to distinguish between advisers which provide good advice and those which are good salespeople but may sacrifice the quality of advice for maximising the volume of business generated. Key indicators may be persistency rates and the level and nature of complaints. Consideration should also be made to the way in which adviser firms oversee and monitor the activities of its staff. For example, performance objectives should seek to identify, and deter, unnecessary churn in client's portfolios.

Q14: Do you agree that Adviser Charging should be applied where individual advice is given on GPPs? Do you think that the principles of Adviser Charging should be applied to non-advised GPP business, and if so how?

The AIC has no comment to make on this issue.

Q15: Do you think changes are needed to the way that we regulate wrap platforms and fund supermarkets?

The AIC **agrees** that a review should be conducted of whether detailed requirements are needed for wrap platforms and fund supermarkets. It is clear that the use of internet and electronic communications is increasingly important and, consequently, distribution methods are adapting quickly. It is therefore appropriate to conduct a review of this area to identify and correct any regulatory gaps.

Q16: Do you think that the principles of Adviser Charging, or any other alternative approaches to remuneration, should be applied to non-advised services?

The AIC **agrees** that this area should be reviewed in due course to identify whether any regulatory changes are required.

Q17: What are your views on this model Code of Ethics as the basis for further PSB/FSA consideration and consultation?

The AIC supports the concept of introducing a new Code of Ethics. This will help to raise the standards applied by the sector and improve its reputation amongst retail investors. The AIC looks forward to the full consultation on the proposed code.

The AIC **recommends** that the Code of Ethics forms part of the FSA Handbook as it is fundamental in setting minimum standards of behaviour for the sector. Adoption of the Code should be mandatory for all firms offering investment advice. To ensure that these standards are strictly adhered to, the FSA should be responsible for supervising compliance with the Code through an appropriate mechanism.

Q18: Do you have any comments on this approach to CPD for investment advisers, including comments on any changes that it would involve to current practices?

The proposed approach to CPD for investment advisers seems sensible.

Q19: What consumer detriment, if any, would arise if we implemented the RDR proposals for the sale of retail investment products and took no action on regulating the sale of pure protection products under ICOBS by retail investment firms? We would welcome any evidence on this.

The AIC has no comment to make on this issue.

Q20: Do you have any comments on the cost benefit analysis?

The AIC has no comments on the cost benefit analysis.

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For more information on the issues raised by this paper please contact:

Guy Rainbird, Public Affairs Director, The Association of Investment Companies. E-mail: guy.rainbird@theaic.co.uk

Alison Andrews, Project Manager, The Association of Investment Companies. E-mail: alison.andrews@theaic.co.uk