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The FSA's Retail Distribution Review – Its Impact on Investment Fund Managers

Background

The FSA's Retail Distribution Review ("RDR") will come into effect on 31 December 2012. It is the culmination of six years of consultation and discussion (yielding 19 FSA Consultation Papers), FSA roadshows and industry engagement. It is the most recent step on the long quest of the FSA and its predecessors to reform the distribution of retail investment products in the UK and to address the longstanding problem of bias in the advice given by financial advisers to their retail clients.

The RDR in a Nutshell

The RDR adds new sections to the FSA's Conduct of Business Sourcebook, in particular the rules relating to adviser disclosure and charging in COBS 6. The main requirements apply in the context of "personal recommendations" given to retail clients in relation to "retail investment products", so apply only to "advised" business undertaken for retail clients in the UK. The most significant reform introduced by the RDR is the ban on commission paid by product providers to advisers in exchange for distributing their financial products. In the UK, independent financial advisers (IFAs) are the predominant means of distribution to retail investors, and earn the majority of their income from commission paid by product providers. Despite rules requiring clear disclosure to the customer of the amount of commission received by an IFA, the FSA considers that commission inevitably leads to bias in recommendations given by IFAs to customers and represents a significant part of the overall charges incurred by the customer over the life of its investment, typically being funded by up to half of the annual management fee.

Alongside the ban on commission, the RDR addresses the equally longstanding issue of a retail client investment adviser's independent or non-independent status. "Independent advice" is re-cast to mean a comprehensive and fair analysis of the market for the relevant type of investment product and what was formerly called "tied status", where the adviser only advises on a limited number of products, is re-cast to mean "restricted advice".

The RDR also introduces a new regime intended to improve the retail client industry's professionalism and technical skill. There is a new minimum level of qualification and a requirement for continuing professional standards and for advisers to hold "statements of professional standing".

The Ban on Commission

Post RDR, there can be no commission paid to advisers of UK retail clients. Every retail financial adviser will need to put in place a charging structure which will need to be understood and agreed to by the UK retail client. The sorts of charging structures envisaged range from "fixed fee" or "hourly rate" to "percentage of amount invested" or "total assets under management". In addition to upfront charges, ongoing charges (say a monthly fee) are also permissible if the adviser is genuinely performing an ongoing service.

As every adviser knows, having set their fees, the greater challenge is to obtain payment. The industry and the FSA have paid much focus to structures which facilitate payment of the retail adviser's fee by deductions from the client's subscription in the product. With the client's agreement, it should be permissible for an IFA to obtain its fee by deduction from the amount the client subscribes into the product. Ongoing charges funded directly out of the product (by for instance redemption of units or from income) are theoretically possible, but indications to date are that few product providers will support this, particularly given the complications of confirming the retail client's consent, ensuring the correct number of units are redeemed and the implications of handling the proceeds as client money.

The FSA has provided guidance on the types of permissible facilitation structures and has considered whether any such structures could give a financial incentive to the adviser to recommend one product in favour of another. Deduction of the adviser's charges from the retail client's initial and ongoing investment in the product, and from the client's returns, is allowed. Advisers though may not fund their fees from cash rebates of, for instance, a portion of the management fee paid to the retail client by the manager. The FSA regards such structures as potentially influencing the level of charges which advisers may set and the availability of cash rebates as a factor leading to bias in an adviser's recommendations. The FSA also considers so-called factoring structures, where the adviser receives an accelerated payment upfront of its total charges from the product provider, to be inappropriate, considering that different discount rates offered by different product providers will lead to adviser bias.

The FSA regards any type of charging structure which varies the charge depending on the provider or the type of product (against competing products) which the retail client selects as inappropriate. The FSA has previously provided guidance on the types of "non-monetary benefits" (soft commission) which may be paid by product providers to the advisers, and generally allows these to the extent they are of benefit to the underlying client and generally provided to all advisers.

Scope of Retail Investment Product

The rules apply to a wider range of retail investment products than the pre-RDR packaged product definition. This is achieved through the introduction of a new FSA Handbook definition of "retail investment product", which includes "packaged products" (including life policies and pension schemes), unregulated collective investment schemes, all investment in investment trust savings schemes and structured investment products.

Given that the definition of "retail investment product" includes unregulated collective investment schemes, one of the possible implications of the wider definition of retail investment product is wider promotion of hedge funds and other non-retail schemes. Does a duty to perform a "comprehensive and fair analysis of the relevant market" on the part of an IFA imply a duty to consider unregulated collective investment schemes for investment by the client? The answer is no – the FSA has published guidance which suggests that many IFAs may well not include unregulated schemes within their product range on the basis that they are too risky for their clients. We note separately that the FSA is currently consulting on severely restricting an IFA's ability to promote unregulated collective investment schemes by removing the "suitability" exemption for such promotions.

Effect on Investment Fund Managers

Many UCITS and other retail funds have already created, or are planning to create, an "RDR ready" share class, either by creating a new share class, or by using an existing share class which already carries a lower management fee – in the latter case, where the existing class may not have been much utilized and where time to market is key. The outstanding feature of such a share class is its lower management fee, typically 0.75%, on the basis that the investment manager will not need to fund any commission payments from its management fee. Existing "full" management fee share classes are likely to continue in parallel for the foreseeable future, partly to reflect that they carry the obligation to pay trail commission to the original adviser - there is also some indication that RDR ready share classes will only be available for sale via intermediaries on platforms and not for direct retail sales.

Platforms

Platforms play a crucial role in retail fund distribution, providing fund providers with both a means to distribute on a wholesale basis (when used via IFAs) and ease of administration. The industry expects to see a significant trend towards the use of platforms for both advised and non-advised business. Advisers have to date been querying whether platforms can facilitate payment of their advisory fees. Arrangements whereby the retail client agrees that the advisory fee can be paid out of the cash account maintained by the client on the platform are regarded as helpful facilitation structures. For the time being, platforms can continue their practice of rebating to investors a portion of their commission, potentially providing a pot available for the payment of adviser charges.

In the next phase of RDR, the FSA has platforms firmly in its sights and has recently published a consultation paper (CP 12/12) outlining its proposal to extend the ban on commission to non-advised business undertaken by platforms. The FSA's view is that retail customers' decisions to invest can be influenced by the platform, bearing in mind the quantity of investment research and investment ideas published by platforms and the view of product providers that the payments they make to platform providers are distribution payments. There is also an expectation that platforms will more readily provide access to investments which may not have to date been available on the platform. The FSA has also signaled its intention to ban payments of cash rebates to retail customers' cash accounts on platforms which, in its view, act as a proxy for commission. Going forward, platform providers will need to charge an agreed fee for the service and in the FSA's view the use of cash rebates to cover the fee potentially obscures to the retail customer the cost of providing the service. This may lead to a change in the nature of the services which platforms offer: some may revert to offering simple administrative services rather than playing an active distribution role.

Treatment of Legacy Assets and Top-ups

The treatment of trail commission brings some complexities which need to be addressed in order to ensure that, post-RDR, no further commission is paid on "advised" retail client investments. Trail commission can continue to be paid on the original amount invested, and on the previous level of regular payments, in each case based on advice given pre-RDR. Despite fund provider lobbying, there is no sunset clause for the payment of legacy commission. Where a retail client increases his level of regular payments or makes top-up investments on the basis of advice from the IFA, the IFA cannot earn commission from the increased amounts, but the IFA can earn commission from the increased amounts if the top-up is due to an automatic increase pre-agreed with the retail client, or, somewhat counter-intuitively, is at the client's initiative. For "advised" top-ups which cannot pay commission, retail clients will normally be steered to either a RDR ready share class (paying a lower management fee) or benefit from the lack of commission by, for instance, increased allocation in the product. Ensuring that the retail client invests in the correct share class and calculating the level of commission to be paid will rely on clear disclosure by the IFA to the product provider.

Distribution agreements with IFAs will need to ensure that the IFA discloses in respect of each investment whether the investment is "advised" or "non-advised".

Creating an RDR Ready Share Class

The FSA's expectation is that funds will pass the saving on commission to the retail investor. In order to do that, funds will create a new share class or use an existing share class. Some funds have considered reducing the minimum investment required in an existing institutional share class, which does not carry a large bundled commission charge, to convert it into an RDR ready share class. One method for non-UK funds to do this is to use a "wrapper" for the UK retail market in relation to the institutional share class, with the minimum subscription amount waived or reduced by means of the wrapper. In considering this conversion, it is important to consider the impact on non-UK sales of this share class (given that RDR's scope is UK retail only) and the impact on existing institutional shareholders (as it potentially allows all institutional shareholders to reduce their holding to the new minimum).

The creation of a new RDR share class can often be relatively straightforward, although any manager will need to consider across its funds the marketing implications of offering a retail share class in one fund exclusively in the UK at a substantially lower management fee than the retail share class available outside the UK. There is also a question as to whether an EU adviser can continue to recommend to its retail clients a commission paying non-RDR share class in favour of a cheaper RDR share class (if one is available), given its duty of best execution to the customer.

MiFID II

In terms of EU wide legislative change, the payment of commission to both retail and professional clients is likely to be dealt with in the new version of the Markets in Financial Instruments Directive (MiFID II). In 2011, the European Commission proposed a ban on firms which provide investment advice on an independent basis or which provide portfolio management services from receiving third party commissions in relation to those services. Unlike RDR, the MiFID II ban would extend to services provided to professional clients as well as retail clients. The RDR ban also does not extend to portfolio management services where no personal recommendation is not made.

On 26 October 2012, the European Parliament approved a revised version of MiFID II which includes a ban on the acceptance of commission in relation to advice or portfolio management services, but only where the firm has informed the client that the advice is given on an independent basis. However, this revised draft expressly permits Member States to adopt more restrictive measures.

The draft directive now goes to the European Council for approval or for amendment and reconciliation with the European Parliament's draft in accordance with the "co-decision" process. The Directive is not expected to be implemented before 2014.

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