New UK Distribution Rules Effective December 31 – the Impact on Fund Managers

The UK's Retail Distribution Review ("RDR") comes into force on December 31, 2012. Despite its title, the RDR will not be limited to the protection of investors that might traditionally be considered to be retail. The RDR may be relevant to anyone – including the US adviser to a private or other fund (a "Fund Manager") – who markets a fund using a Financial Services Authority ("FSA") authorized intermediary in the United Kingdom ("UK") (such authorized intermediary is referred to in this alert as a "Financial Adviser"), where that Financial Adviser also provides a "personal recommendation" to an investor in the fund. In particular, the RDR may require Fund Managers to revisit the compensation arrangements which it has in place with any Financial Adviser who distributes the fund in the UK to investors that fall within the definition of "retail client" for purposes of these rules, including certain high net worth individuals.

What is the RDR?

The RDR seeks to address certain issues within the UK retail market by:

- improving the clarity with which Financial Advisers describe their services and charges to clients;
- addressing the potential for Financial Adviser remuneration to impact negatively upon clients, particularly as a result of commission bias; and
- increasing the professional standards of Financial Advisers.

How is a regime aimed at Financial Advisers relevant to Fund Managers, particularly non-UK Fund Managers?

Although discretionary investment management business (as well as generic advice and execution only services) is outside the scope of the RDR, the RDR may have an impact on any Fund Manager who manages a fund in which a UK investor invests directly or indirectly. As mentioned above, where a UK investor has made a direct or indirect investment in a fund as the result of a "personal recommendation" made by a Financial Adviser, the RDR may impact the manner in which the Fund Manager can compensate the Financial Adviser.[1]

How can a "retail" regime be relevant to Fund Managers of private or other funds aimed at sophisticated or high net worth investors?

The FSA Rules apply to distribution activities in respect of "retail clients," defined as anyone who is not an "eligible counterparty" or a "professional client" within the meaning of the Markets in Financial Instruments Directive ("MiFID"). These definitions are set out in Appendix One to this note. High net worth individuals and sophisticated investors do not fall automatically within these definitions, and may only be "opted up" to become "professional clients," subject to the Financial Adviser satisfying certain requirements.

In addition to traditional retail funds, such as UCITS and other UK registered funds, the RDR applies to units in an "unregulated collective investment scheme," such as a non-UK managed hedge fund. In addition

[1] Under the FSA Handbook of Rules and Guidance ("FSA Rules"), a "personal recommendation" includes advice on the merits of buying, selling or subscribing for any investment or exercising a right conferred by an investment which is presented as suitable for the person to whom it is made, or is based on a consideration of the circumstances of that person. A recommendation is not a personal recommendation if it is issued exclusively through distribution channels or to the public. The concept is derived from the Markets in Financial Instruments Directive.

to interests or units in funds, the RDR applies to "packaged products" such as life policies, pension schemes and all investment in investment trust savings schemes and structured investment products.

What are the particular FSA requirements governing the arrangements between Fund Managers and Financial Advisers?

The FSA Rules will require that a Financial Adviser:

(a) only be remunerated for a personal recommendation (and any other related services provided by the firm) by "adviser charges";[2]

(b) not solicit or accept any other commissions, remuneration or benefit of any kind in relation to the personal recommendation or any other related service, regardless of whether it intends to refund the payments or pass the benefits on to the investor; and

(c) not solicit or accept adviser charges in relation to the fund which are paid out or advanced by another party over a materially different time period, or on a materially different basis, from that in or on which the adviser charges are recovered from the investor.[3]

What changes will the FSA expect to the arrangements between Fund Managers and UK distributors?

In light of the requirements above, the manner in which Fund Managers compensate the Financial Advisers who distribute their funds to retail investors (as defined for purposes of the RDR) in the UK may need to change:

- Ongoing charges will only be permitted where a Financial Adviser provides a continuing service to the UK investor in question.
- A Fund Manager will no longer be able to have any influence or input in setting the remuneration paid to a Financial Adviser with respect to advice provided by the Financial Adviser to an investor in the fund.
- A Fund Manager will have to ensure that the charges disclosed to a UK investor are clear and do not conceal the distinction between the fees charged by a Fund Manager and those charged by a Financial Adviser.
- The practice whereby a Fund Manager (a) pays a Financial Adviser the full Financial Adviser charge upfront using the Fund Manager's own funds at a discounted rate, and (b) seeks recovery of the balance of the Financial Adviser charge from funds which a UK investor gives to the Fund Manager for the purpose of investment, will be prohibited.

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[2] The FSA Rules define an "adviser charge" as any form of charge payable by or on behalf of a retail client to a firm in relation to the provision of a personal recommendation by the firm in respect of a retail investment product (or any related service provided by the firm) which is agreed between that firm and the retail client in accordance with the rules on adviser charging and remuneration.

[3] See the Conduct of Business Sourcebook ("COBS") Rule 6.1A. COBS Rule 6.1B will supplement these requirements with a prohibition on FSA authorized product providers against the payment of any commissions, remuneration or benefit of any kind except those that facilitate the payment of adviser charges from a retail client's investments.

Has the FSA provided any indication of how it would treat any attempted "work around"?

Yes. In a "Dear CEO" letter dated October 1 to fund distributors, the FSA raised its concerns that certain firms may be looking to "work around" the adviser charging rules by soliciting or providing payments / benefits. The FSA expressed the view that this might mean that Financial Advisers could continue to provide "biased" advice to investors (when recommending a Fund Manager) and also make some Financial Adviser charges look lower than others simply because of the deals and arrangements they have in place with Fund Managers.

The FSA indicated that it would challenge Financial Advisers who pursue such deals and arrangements and will take robust action where it sees evidence that Financial Advisers are circumventing the rules. It emphasized that its approach was not about banning arrangements which are reasonable and comply with its rules. Instead, it was cracking down on those Financial Advisers that, in the FSA's view, are seeking to get an unfair advantage over others.

Does the RDR apply to other European countries?

The RDR applies in the UK only. However, legislators in other European countries such as the Netherlands are looking to adopt similar laws. Moreover, legislative steps are being taken which could eventually impose similar requirements across the European Economic Area ("EEA"). This includes revisions to MiFID – in a set of proposals known as "MiFID II" – which are intended to prohibit the acceptance of commissions in relation to the provision of advice or portfolio management services where a Financial Adviser holds itself out as independent. It also includes the Packaged Retail Investment Products Regulation ("PRIPs"), which seeks to impose restrictions and requirements that are similar to those in the RDR to the distribution of packaged retail products across the EEA. Both MiFID II and PRIPs are not due for implementation until the end of 2014 at the earliest.

Next steps?

FSA-authorized Financial Advisers should have contacted Fund Managers with whom they have entered into distribution arrangements. Fund Managers who enter into distribution arrangements with Financial Advisers in the future will need to understand the RDR. Ropes & Gray would be happy to advise any Fund Managers or Financial Advisers on their options for ensuring that any such arrangements comply with the RDR. For further information, please contact your regular Ropes & Gray adviser.

Appendix One

1. Professional Clients

A. Per Se Professional Clients

Each of the following is a per se professional client unless and to the extent it is an eligible counterparty or is given a different categorization under chapter 3 of COBS:

(1) an entity required to be authorized or regulated to operate in the financial markets. The following list includes all authorized entities carrying out the characteristic activities of the entities mentioned, whether authorized by an EEA State or a third country and whether or not authorized by reference to a directive:

- (a) a credit institution;
- (b) an investment firm;
- (c) any other authorized or regulated financial institution;
- (d) an insurance company;
- (e) a collective investment scheme or the management company of such a scheme;
- (f) a pension fund or the management company of a pension fund;
- (g) a commodity or commodity derivatives dealer;
- (h) a local authority;
- (i) any other institutional investor;

(2) in relation to MiFID or equivalent third-country business a large undertaking meeting two of the following size requirements on a company basis:

- (a) balance sheet total of EUR 20,000,000;
- (b) net turnover of EUR 40,000,000;
- (c) own funds of EUR 2,000,000;

(3) in relation to business that is not MiFID or equivalent third-country business a large undertaking meeting any one of the following conditions:

- (a) a body corporate (including a limited liability partnership) which has (or any of whose holding companies or subsidiaries has) (or has had at any time during the previous two years) called up share capital or net assets, of at least £51 million (or its equivalent in any other currency at the relevant time);
- (b) an undertaking that meets (or any of whose holding companies or subsidiaries meets) two of the following tests:
  - (i) a balance sheet total of EUR 12,500,000;
  - (ii) a net turnover of EUR 25,000,000;
  - (iii) an average number of employees during the year of 250;

(c) a partnership or unincorporated association which has (or has had at any time during the previous two years) net assets of at least £5 million (or its equivalent in any other currency at the relevant time) and calculated in the case of a limited partnership without deducting loans owing to any of the partners;

(d) a trustee of a trust (other than an occupational pension scheme, personal pension scheme or stakeholder pension scheme) which has (or has had at any time during the previous two years) assets of at least £10 million (or its equivalent in any other currency at the relevant time) calculated by aggregating the value of the cash and designated investments forming part of the trust's assets, but before deducting its liabilities;

(e) a trustee of an occupational pension scheme or a trustee or operator of a personal pension scheme or stakeholder pension scheme where the scheme has (or has had at any time during the previous two years):

(i) at least 50 members; and

(ii) assets under management of at least £10 million (or its equivalent in any other currency at the relevant time);

(f) a local authority or public authority.

(4) a national or regional government, a public body that manages public debt, a central bank, an international or supranational institution or another similar international organisation;

(5) another institutional investor whose main activity is to invest in financial instruments (in relation to the firm's MiFID or equivalent third-country business) or designated investments (in relation to the firm's other business). This includes entities dedicated to the securitisation of assets or other financing transactions.

B. Elective Professional Clients

A firm may treat a client as an elective professional client if it complies with (1) and (3) and, where applicable, (2):

(1) the firm undertakes an adequate assessment of the expertise, experience and knowledge of the client that gives 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 (the "qualitative test");

(2) in relation to MiFID or equivalent third-country business in the course of that assessment, at least two of the following criteria are satisfied:

(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 EUR 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 (the "quantitative test"); and

(3) the following procedure is followed:

(a) the client must state in writing to the firm that it wishes to be treated as a professional client either generally or in respect of a particular service or transaction or type of transaction or product;

(b) the firm must give the client a clear written warning of the protections and investor compensation rights the client may lose; and

(c) the client must state in writing, in a separate document from the contract, that it is aware of the consequences of losing such protections.

2. Eligible Counterparties

A. Per Se Eligible Counterparties

Each of the following is a per se eligible counterparty (including an entity that is not from an EEA State that is equivalent to any of the following) unless and to the extent it is given a different categorisation under this chapter:

(1) an investment firm;

(2) a credit institution;

(3) an insurance company;

(4) a collective investment scheme authorized under the UCITS Directive or its management company;

(5) a pension fund or its management company;

(6) another financial institution authorized or regulated under EU legislation or the national law of an EEA State;

(7) an undertaking exempted from the application of MiFID under either Article 2(1)(k) (certain own account dealers in commodities or commodity derivatives) or Article 2(1)(l) (locals) of that directive;

(8) a national government or its corresponding office, including a public body that deals with the public debt;

(9) a central bank;

(10) a supranational organisation.

B. Elective Eligible Counterparties

A firm may treat a client as an elective eligible counterparty if:

(1) the client is an undertaking and:

(a) is a per se professional client (except for a client that is only a per se professional client because it is an institutional investor under COBS 3.5.2 R (5)) and, in relation to business other than MiFID or equivalent third-country business:

(i) is a body corporate (including a limited liability partnership) which has (or any of whose holding companies or subsidiaries has) called up share capital of at least £10 million (or its equivalent in any other currency at the relevant time); or

(ii) meets the criteria in the rule on meeting two quantitative tests (COBS 3.5.2 R (3)(b)); or

(b) requests such categorisation and is an elective professional client, but only in respect of the services or transactions for which it could be treated as a professional client; and

(2) the firm has, in relation to MiFID or equivalent third-country business, obtained express confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty.