

**Notification and justification for retention of the FSA’s requirements on the use of dealing commissions (“Provisions”) under Article 4 of Directive 2006/73/EC (“Level 2 Directive”) implementing Directive 2004/39/EC (“Level 1 Directive”).**

1. Under soft commission and bundled brokerage arrangements goods and services are supplied to a portfolio manager in return for business put through a broker. The FSA introduced the use of dealing commission provisions in January 2006 in order to address specific market failures arising out of these arrangements that were not adequately addressed by its general provisions on inducements. This paper explains how the Provisions satisfy the requirements of the Article 4 test. It is structured as follows:
  - Explanation of how the Provisions go beyond the requirements of the Level 2 Directive;
  - A description of the specific risks to investor protection and to market integrity addressed by the Provisions and explanation why they are not adequately addressed by the Level 2 Directive;
  - Explanation of why the Provisions are proportionate; and,
  - Explanation of why the Provisions do not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive.
2. The FSA will apply a modified version of the Provisions after 1 November 2007 to ensure consistency and a clear relationship with the inducements provisions that will apply under MiFID.
3. Unless indicated otherwise, references in this notification to the rules of the FSA are references to rules in Policy Statement 07/14: Reforming Conduct of Business Regulation.<sup>1</sup>
4. This notification replaces the notification made by the United Kingdom on 31 January 2007 in relation to the same subject matter.

*In what way are the Provisions additional to those in the Level 2 Directive?*

5. The ways in which the Provisions are or could be said to be additional to those in the Directive are:
  - (1) The Provisions limit a portfolio manager’s use of dealing commission to the purchase of 'execution' and 'research' services – that is, they impose restrictions on the type of goods and services that may be paid for out of client dealing commissions (“**Services Restriction**”)<sup>2</sup>. The Services Restriction builds upon the restrictions on the

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<sup>1</sup> [http://www.fsa.gov.uk/pubs/policy/ps07\\_14.pdf](http://www.fsa.gov.uk/pubs/policy/ps07_14.pdf). Defined terms are shown in italics in that consultation paper. Where amendments to defined terms are proposed, these changes are shown in Annex A to the legal instrument attached to the policy statement. Where no changes are proposed to those defined terms, they should be read in accordance with the existing FSA glossary, which can be accessed at <http://fsahandbook.info/FSA/html/handbook/Glossary>.

<sup>2</sup> COBS 11.6.3R to 11.6.5E.

types of inducements that may be accepted by firms under Article 26(b) of the Level 2 Directive and is or could be seen as more restrictive than them. To the extent that it is, it is an additional requirement to those in the Directive.

(2) The Provisions require a portfolio manager to make an adequate prior disclosure to customers of the firm's policy relating to the receipt of goods or services that relate to the execution of trades or to the provision of research ("**Prior Disclosure**")<sup>3</sup>. Disclosure by a firm under the Prior Disclosure requirements will constitute the general summary disclosure of permitted benefits required by the final paragraph of Article 26 of the Level 2 directive. The Prior Disclosure requirements provide more focus around the way in which the summary disclosure should be made in the context of the receipt of execution and research services. However, they still only require the disclosure to be made at an "adequate" level of detail and do not require comprehensive *ex ante* disclosure of such benefits.

(3) The Provisions require a portfolio manager to make an adequate disclosure at least once a year of the details of the goods and services received by the investment firm that relate to the execution of trades or the provision of research ("**Periodic Disclosure**")<sup>4</sup>. No such periodic disclosure is required by Article 26 of the Level 2 Directive.

6. Articles 30 and 33 (Information about the firm and its services for retail clients and potential clients, and, Information about costs and associated charges), and Section 4 (Reporting to clients) and Section 5 (Best Execution) of Chapter III "Operating conditions for investment firms" of the Level 2 Directive are also relevant to the Provisions.

*What are the specific risks to (i) investor protection or to (ii) market integrity that the requirements address that are not adequately addressed by the Level 2 Directive?*

7. In 2003 the FSA conducted a review of bundled brokerage and soft commission arrangements. Market failures identified from the Myners review of institutional investment in the UK related to the use of 'bundled' and 'softed' commission. Under soft commission and bundled brokerage arrangements goods and services – such as investment research, seminars, external publications and data price feeds - are supplied to the portfolio manager in return for business put through a broker. The broker's charges are higher in order to offset the services that are supplied to the portfolio manager. Such arrangements incentivise portfolio managers to over trade and obtain poor execution in order to generate soft commission credits and over-consume associated services and non-execution services such as investment research and data services, which result in higher costs for investors.
8. Under the regulatory requirements then in place such arrangements were disclosed in general terms to the portfolio manager's client and the charges passed on directly to end-investors. This lack of transparency created information asymmetries that made

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<sup>3</sup> COBS 11.6.12R & 16R.

<sup>4</sup> COBS 11.6.15R, 16R & 18E.

it difficult for clients to tell whether the portfolio manager was acting in their best interests including obtaining sufficient value for money on their behalf.

9. The specific risks to investor protection and to market integrity resulting from such arrangements that are not adequately addressed by the Directive are:

(1) the risk that end-investors will suffer higher charges than they should as a result of the distortions in the market for which there are no adequate correcting mechanisms;

(2) the lack of transparency in the goods and services paid for by customers out of dealing services.

10. The FSA's current provisions as described in paragraph 5 above seek to address these specific risks. There are two main effects of the way in which the Services Restriction restricts the range of services that can be purchased with client dealing commissions. The first is the possible reduced efficiency of charging for certain services unbundled compared to bundled. But, the services that the Services Restriction prevents portfolio managers from purchasing with client dealing commissions have low economies of scope with execution. This implies that excluding them would not add significant costs to investment firms, but will generate savings to consumers. The second and more significant effect, and one of the purposes behind the Services Restriction, is a reduction in portfolio managers' incentives to purchase additional services that may not be necessary. Such a reduction results in:

- the reduction of excessive consumption of services that would otherwise be 'softed' or 'bundled';
- the likelihood that portfolio managers reduce excessive trading because they are no longer able to obtain credits for services their clients may not necessarily require; and
- increased cost consciousness of portfolio managers when paying for services with commissions.

11. The more focused requirements for the content of the summary disclosure of inducements bring some additional costs for portfolio managers. However, benefits should arise from:

- increased competitive pressure on portfolio managers, if as a result, investors better scrutinize and compare portfolio managers' usage of their commission; and
- increased pressure on brokers to provide effective pricing and valuation of their execution and research services, thereby making portfolio managers more conscious of costs and the need to obtain better value for money from brokers. The use of Periodic Disclosure in addition to Prior Disclosure is necessary to ensure this pressure is maintained on an on-going basis and also to enable disclosure to include concrete details of the softened services received rather than purely generic information, thereby increasing transparency.

12. Article 26 of the MiFID Level 2 directive sets out three criteria that a payment or receipt needs to meet to be accepted:

- it must be designed to enhance the quality of the relevant service to the client;
  - it must not impair compliance with the firm's duty to act in the best interests of the client; and
  - the arrangements must be disclosed to clients, in at least summary form, prior to the provision of relevant investment or ancillary services.
13. This provision of MiFID does not specifically focus on the application of these principles in the relevant fields. We do not believe a general approach alone will adequately address the failures in the UK market identified above in relation to the use of dealing commission and therefore feel it is necessary to build upon these general requirements in this area. In particular there is a wide range of services that an investment firm may claim would be permitted under Article 26 to receive from a broker and that could be paid for out of dealing commission charged to clients. Such services might include seminars, external publications and data price feeds. These are services which, prior to the introduction by the FSA of its own restrictions, were provided by brokers to portfolio managers out of dealing commissions that were recharged to clients. Article 26 is cast at similar level of generality to the FSA provisions that were then in place. Given the strong incentives for portfolio managers to reduce their out of pocket expenses and for brokers to seek to attract order-flow it is evident that in the absence of specificity provided by the Services Restriction, reliance on article 26 would not be sufficient to address the market failures. Further, the MiFID provisions do not specifically cover the requirement for disclosure to clients of the goods or services that relate to execution of trades and the provision of research. Our experience indicates that solely imposing requirements at the level of detail of MiFID would not address the market failures and it is therefore necessary to flesh out the general MiFID provisions with more specific requirements.
14. The third test might be said to allow the firm to rely on a high level initial disclosure, which would be supplemented only where clients requested further information. Simply covering this under the general disclosure of the firm's inducements and other arrangements would reduce its impact on the information asymmetries when compared to a separate and detailed disclosure focussed on use of dealing commission arrangements.
15. The absence of a requirement for periodic reporting would reduce the incentives given to firms and to their clients by the Periodic Disclosure requirement.

**In what way are the risks of particular importance in the circumstances of the market structure of the United Kingdom?**

16. Recital 10 to the Level 2 Directive clarifies that the market structure of the Member State in question includes the behaviour of firms and consumers in that market.
17. A number of research exercises have been carried out in the UK market to assess the extent of and the economic effects of soft commission and bundled brokerage arrangements. The FSA, in developing its proposals, has also issued 3 detailed consultation papers directed at UK market participants and held extensive discussions over a number of years with those participants to understand the issues and economic effects and how they might best be addressed in the circumstances of the structure of

the UK market. The Annex to this Notification and Justification lists the FSA-produced reports and other relevant research material. We are able to provide hard copies of the material on request. As explained in summary below this gives good reason to conclude that the specific risks addressed by the requirements are of particular importance in the circumstances of the market structure of the UK.

18. In 2003 the FSA carried out a review of soft commission and bundled brokerage arrangement in the UK and has published a research report on soft commission and bundled brokerage services dated April 2003 prepared by the research company OXERA. The review showed there to be significant market distortions in the UK. If these were permitted to be retained then costs to investors, including consumers would be higher than necessary, tending over time to reduce overall levels of investment and savings. For example, the research commissioned by the FSA noted commission credits of £90 million annually were spent on market and price information services. The report provided evidence of over consumption, noting that only about 50% of portfolio managers would continue to purchase these market and price information services following the new provisions and, of those, about 30% said that they would buy less of the services. It is clear also therefore that the market failures would persist and would not self-correct.
19. And, to put the Provisions into further context commissions paid by portfolio managers to brokers for the execution of deals on behalf of their clients are a significant cost of portfolio management. In 2000, UK fund managers paid about £2.3 billion (about €3.3 billion) in commissions to UK brokers in commission charges from their customer funds. The value of soft commission credits provided is estimated at around £160 million.
20. The FSA will be carrying out a post-implementation review of the Provisions but this will not be complete until 2008. An accurate assessment of the effect in practice of the requirements is therefore not available, although within the UK they are now accepted as standard practice. It is evident however that as a result of the FSA introducing the provisions some portfolio managers have ceased to use soft commission and bundled brokerage arrangements while others have restricted their use of softened services in accordance with the Provision.
21. The impact of these measures is amplified by the fact that the fund management industry is of vital importance to the well being of the UK financial services industry and to consumers. For example, assets under management by UK-based fund managers amounted to about £2,800 billion<sup>5</sup> as at 31 December 2005 (about €4,000 billion), covering pensions funds, insurance funds, collective investment schemes, investment trusts, private clients and other products.

*Why are the requirements proportionate?*

22. As described above the Provisions were introduced because the general FSA provisions on inducements (which are cast at a similar level of generality to those under Article 26 of the Level 2 Directive) and soft commission were inadequate to

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<sup>5</sup> Publication by Investment Management Association – "Asset Management Survey" published July 2006

address the market failures in this area. Before introducing the Provisions the FSA considered whether alternative measures would be a more proportionate way of addressing the market failures but concluded that the Provisions were the most proportionate.

23. For example, an alternative the FSA considered but rejected was for portfolio managers to rebate the costs of services, other than execution, back to the client where the payment of these services was made from client dealing commissions. This would prevent these services from being provided together with trade execution, and being priced into the rate or amount of broker commission charged to the fund. The FSA rejected this idea after consultation with industry on the basis that this proposal did not take fully into account the broader structural impacts of change and could have unintended adverse consequences for UK portfolio management and equity trading. The cost-benefit balance of intervening in the market in this way would therefore be less proportionate than the one achieved through the Provisions. Many respondents from the industry stated that this alternative would adversely affect competition between firms in the UK, the ability of UK fund managers to compete internationally, the supply of and demand of investment research and equity trading. The FSA concluded that the rebating system would prove more costly and complex for firms to implement, in particular firms could face a conflict of interest over the calculation of the rebate.
24. The FSA's decision to introduce the Provisions was also informed by extensive consultation and thorough cost-benefit analysis on the UK market (links to relevant material are contained within the Appendix). This cost benefit analysis estimated that the one-off costs of the Services Restriction would be in the region of £3.6 million to portfolio managers and brokers, to amend their lists of approved services, communicate the changes to staff and provide training on the new provisions. Continuing costs were expected to be very small, as once firms had made the necessary changes to their systems they would not need to devote any additional resources to monitoring compliance or advising on compliance with the new requirements.
25. These costs are calculated against annual cost savings due to a reduction in expenditure of softing and bundling services of between £2.4 million and £2.8 million. On a discounted cashflow basis this gives a reduction of costs to investors of about £35m to £40m.
26. The estimated costs of the Prior and Periodic Disclosure requirements were one off compliance costs of £6.1 million for portfolio managers and £6.2m for brokers. The on-going estimated costs are £4.3 million per year for portfolio managers and £2 million for brokers. However, these costs are offset against yearly savings due to a reduction of softing and unbundling services of between £50.4 million and £60.1 million.
27. The one-off costs to portfolio managers and brokers in relation to the Provisions will have already been spent by firms when they updated their processes and procedures to comply with the new provisions which became effective on 1 January 2006. These one-off costs cannot now be recovered.

28. The studies also suggested there could be other significant benefits that it was not appropriate to quantify.

*Do the requirements restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC.*

29. The Provisions relate to matters within the scope of Article 19(1) of the Level 1 Directive. They will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC. This is because the FSA will not apply them to firms exercising rights under Article 31 and will only apply them to firms exercising rights under Article 32 in the circumstances contemplated by Article 32(7).

## **APPENDIX**

### ***Reference material***

#### FSA produced reports

<b>Name of publication / report</b>	<b>Date published</b>
Consultation Paper (CP176) – Bundled brokerage and soft commission arrangements  <a href="http://www.fsa.gov.uk/pages/Library/Policy/CP/2003/176.shtml">www.fsa.gov.uk/pages/Library/Policy/CP/2003/176.shtml</a>	April 2003
Policy Statement (PS04/13) – Bundled brokerage and soft commission arrangements (feedback on CP176)  <a href="http://www.fsa.gov.uk/Pages/Library/Policy/Policy/2004/04_13.shtml">www.fsa.gov.uk/Pages/Library/Policy/Policy/2004/04_13.shtml</a>	May 2004
Policy Statement (PS04/23) – Bundled brokerage and soft commission arrangements (update in issues arising from PS04/13)  <a href="http://www.fsa.gov.uk/pubs/policy/ps04_23.pdf">www.fsa.gov.uk/pubs/policy/ps04_23.pdf</a>	November 2004
Consultation Paper (CP05/5) – Bundled brokerage and soft commission arrangements: proposed rules  <a href="http://www.fsa.gov.uk/pubs/cp/cp05_05_newsletter.pdf">www.fsa.gov.uk/pubs/cp/cp05_05_newsletter.pdf</a>	March 2005
Policy Statement (PS05/9) – Bundled brokerage and soft commission arrangements (feedback on CP05/5 and final rules)  <a href="http://www.fsa.gov.uk/Pages/Library/Policy/Policy/2005/05_09.shtml">www.fsa.gov.uk/Pages/Library/Policy/Policy/2005/05_09.shtml</a>	July 2005
Consultation Paper (CP 06/19) - Reforming Conduct of Business Regulation - Including proposals for implementing relevant provisions of the Markets in Financial Instruments Directive, and related changes to SYSC, DISP, TC, SUP and other Handbook modules.  <a href="http://www.fsa.gov.uk/Pages/Library/Policy/CP/2006/06_19.shtml">www.fsa.gov.uk/Pages/Library/Policy/CP/2006/06_19.shtml</a>	October 2006
Policy Statement (PS 07/14) – Reforming Conduct of Business Regulation Final feedback on CP 06/19  <a href="http://www.fsa.gov.uk/pubs/policy/ps07_14.pdf">http://www.fsa.gov.uk/pubs/policy/ps07_14.pdf</a>	July 2007

#### Other published reports

<b>Name of publication / report</b>	<b>Date published</b>
Myners review on 'institutional investment' in the UK on behalf of HM Treasury  <a href="http://www.hm-treasury.gov.uk./media/2F9/02/31.pdf">www.hm-treasury.gov.uk./media/2F9/02/31.pdf</a>	March 2001
Oxera report in relation to CP176	April 2003

<p>'An assessment of soft commission and bundled brokerage services in theUK'</p> <p><a href="http://www.fsa.gov.uk/pubs/cp/cp176_oxera_assessment.pdf">www.fsa.gov.uk/pubs/cp/cp176_oxera_assessment.pdf</a></p>	
<p>Oxera report in relation to CP176</p> <p>'Cost-Benefit analysis of the FSA's policy proposition on soft commission and bundling'</p> <p><a href="http://www.fsa.gov.uk/pubs/cp/cp176_oxera_cba.pdf">www.fsa.gov.uk/pubs/cp/cp176_oxera_cba.pdf</a></p>	<p>April 2003</p>
<p>Charles River Associates report in relation the cost and benefits carried out on behalf of the Investment Management Association (IMA)</p> <p><a href="http://www.investmentuk.org/news/research/2004/soft_commissions/crar_e_researchcp176.pdf">www.investmentuk.org/news/research/2004/soft_commissions/crar_e_researchcp176.pdf</a></p>	<p>October 2003</p>
<p>Deloitte report in response to CP176</p> <p>'Assessment of the economic impact of the implementation of the proposals contained within FSA consultation document CO176 with reference to incumbent fund manager's ability to compete in the UK market'</p> <p><a href="http://www.fsa.gov.uk/pubs/Policy/04_13/report.pdf">www.fsa.gov.uk/pubs/Policy/04_13/report.pdf</a></p>	<p>April 2004</p>
<p>Oxera first stage report identifying the baseline for the FSA's post-implementation review</p> <p>'Bundled brokerage and soft commission arrangements: performance management framework - an update'</p> <p><a href="http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2006/bundled_brokerage.shtml">http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2006/bundled_brokerage.shtml</a></p>	<p>October 2006</p>

## **Notification and justification for retention of certain requirements relating to the market for packaged products under Article 4 of Directive 2006/73/EC ("Level 2 Directive") implementing Directive 2004/39/EC ("Level 1 Directive")**

1. In developing its proposals to implement the MiFID Level 1 and 2 Directives, the UK Financial Services Authority ("FSA") has rigorously reviewed its conduct of business requirements for investments, to take account of the Level 1 and Level 2 Directives and more generally to reduce the amount of detailed and prescriptive material. This paper explains the rationale for the requirements the FSA has retained in a few areas relating to the market for packaged products in the UK (see below), which could require notification under Article 4.
2. These requirements relate to:
  - a) The accuracy of representations about the nature of the service offered;
  - b) Information about products; and
  - c) Information about the costs of services (hard disclosure of commission and commission equivalent).
3. Unless indicated otherwise, references in this notification to the rules of the FSA are references to rules in Policy Statement 07/14: Reforming Conduct of Business Regulation.<sup>6</sup>
4. This notification replaces the notification made by the United Kingdom on 31 January 2007 in relation to the same subject matter.

### **Section 1: background description of the relevant UK market and risks**<sup>7</sup>

#### ***What are packaged products?***

5. The UK uses the description "packaged products" to mean units in regulated collective investment schemes (which include units in UCITS and certain non-UCITS retail schemes), shares in investment trusts,<sup>8</sup> life assurance policies with an investment component and certain types of pension product. These products are often designed for, and sold to, retail clients.

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<sup>6</sup> [http://www.fsa.gov.uk/pubs/policy/ps07\\_14.pdf](http://www.fsa.gov.uk/pubs/policy/ps07_14.pdf). Defined terms are shown in italics in that consultation paper. Where amendments to defined terms have been made, these changes are shown in Annex A to the legal instrument attached to the policy statement. Where no changes have been made to those defined terms, they should be read in accordance with the existing FSA glossary, which can be accessed at <http://fsahandbook.info/FSA/html/handbook/Glossary>.

<sup>7</sup> As well as putting the requirements covered by this notification into context, this section supports, and forms part of, the justifications in each of the following sections. In particular, it is relevant in explaining why these requirements are of particular importance in the circumstances of the market structure in the UK.

<sup>8</sup> i.e. listed close-ended collective investment undertakings that are companies. These are treated as packaged products when sold through a dedicated service as opposed to a more general equity brokerage service.

6. Some packaged product sales are within MiFID scope (e.g. units in collective investment undertakings sold by MiFID firms) and some are outside (e.g. life assurance-based investment products and personal pensions). However, scope and non-scope packaged products are frequently 'substitutable' in meeting the investment objectives of a client, and often sold in a similar way by the same intermediaries. Furthermore, some intermediaries that distribute these products fall within the scope of MiFID while others are exempt (for example, firms exempted under Article 3 of the Level 1 Directive).
7. As the Commission has noted in the past,<sup>9</sup> differential regimes in such circumstances run the risk of competitive distortion. There is also a risk of confusion among firms and consumers where the reason for treating comparable in-scope and out-of scope investment products and firms differently may be unclear.

***Packaged products: characteristics and significance in the UK market***

8. We estimate that 35-40% (about £3,450bn) of funds under management in the UK is held in a packaged product.<sup>10</sup> Data on the total size of the UK packaged product market is hard to establish. However, as an indication, and taking just the products of one industry sector, we estimate that approximately 2.6 million new contracts for investment and savings products, collective investment schemes and pension products were sold in the UK in 2005 alone, amounting to nearly £8bn in income.<sup>11</sup>
9. In order to encourage saving, UK taxpayers are allowed to invest up to £7,000 each year in an Individual Savings Account (ISA), which allows them to shelter those investments from income and capital gains taxes. These tax benefits have made ISAs a major element of the UK retail investment market. While ISAs can be used for direct investment in shares and bonds, it is much more common for them to be used to hold investments in packaged products. Of £70,382m invested in securities through ISAs in 2006, over £55,124m was invested in the form of packaged products.<sup>12</sup>
10. Packaged products are of particular importance to consumers in the UK for two main reasons. First, in comparison to most other EU Member States, the UK places a greater (and increasing) reliance on private provision for retirement and long-term care. Second, the UK has a higher proportion of home ownership and, therefore,

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<sup>9</sup> Green Paper on the EU Framework for Investment Funds, COM (2005) 314 final, 3.3.

<sup>10</sup> Figures derived from IFSL (Fund Management 2005 in the City Business series) ([http://www.ifsl.org.uk/pdf\\_handler.cfm?file=CBS\\_Fund\\_Management\\_2006&CFID=277086&CFToken=81472573](http://www.ifsl.org.uk/pdf_handler.cfm?file=CBS_Fund_Management_2006&CFID=277086&CFToken=81472573))

<sup>11</sup> This reflects our analysis of statistics made available to its members by the Association of British Insurers (ABI), from which we have sought to extract figures relating to packaged product sales. Sales cover both single premium and regular premium products, and income is expressed in terms of the APE (Annual Premium Equivalent).

<sup>12</sup> HM Revenue and Customs, Table 9.6 ISAs: market value of funds as of 5 April 2006 by type of qualifying investment, <http://www.hmrc.gov.uk/stats/isa/menu.htm> (Invested amounts expressed in market value.)

investments that are used to repay mortgage lending.<sup>13</sup> These considerations mean the impact of poor investment choices can have a significantly detrimental effect on UK consumers.

11. Nevertheless, research shows that UK consumers tend to find the products and the associated risks hard to understand, and find it hard to determine the 'price' of a product.<sup>14</sup> In addition, individual consumers in the UK often purchase packaged products relatively infrequently (they are usually bought as long-term investments, not for trading purposes), so have little experience to draw on.<sup>15</sup> This means that the structural information asymmetry between firms and consumers is exacerbated by consumers' limited capability in understanding and choosing these products.<sup>16</sup>
12. Packaged products often have more complex charging structures when compared to direct investment in instruments such as shares and bonds. In particular, charges can be made to cover a range of activities such as product provider administration, fund management, and commission payments made to the intermediary selling the product. The way that these charges are extracted can also differ substantially between competing products and can have significant effects on the performance of a client's investment. Charging structures can also have other important implications for consumers - for example, high 'up-front' charges are likely to make early surrender or encashment unattractive.
13. Because of the typically longer term nature of packaged products, unsuitable sales may be identified only years later. A client may realise only when market conditions change that their capital or 'target' return is not guaranteed. This point can be demonstrated by the fact that there is typically a lead time of many years between such sales and complaints relating to them being brought to the Financial Ombudsman Service, which provides out-of-court redress for retail clients in the UK.

### ***Structure of the UK market: distribution and associated risks***

14. Distribution of packaged products in the UK is often through intermediaries acting as 'advisers' (i.e. making personal recommendations to clients). Because of the complexity of many products and the consumer inexperience outlined above, many consumers rely heavily on advisers. Indeed, we believe that consumers rely on advice

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<sup>13</sup> 30% of UK adult consumers say they have a mortgage, against an EU average of 16%. Source: Special EUROBAROMETER 230 Public Opinion in Europe on Financial Services, European Commission, August 2005, pp16 and 18.

<sup>14</sup> 43% of respondents in the FSA's Financial Capability Baseline Survey who had invested in equities directly or through packaged products had a preference for taking no risk to their capital, and between 16% and 33% of respondents investing in various equity-based products perceived the product to have no risk to capital. Consumer Research 47, FSA, March 2006, pp93-94. See also how people buy, UK Financial Services Consumer Panel Research Paper, July 2005.

<sup>15</sup> 26% of respondents in the FSA's Financial Capability Baseline Survey had not bought any financial product in the last five years. Consumer Research 47, FSA, March 2006, p84. See also p87 for investment products.

<sup>16</sup> Financial Capability Baseline Survey, p101.

to a much greater extent in the UK retail investment market than do consumers in other Member States.

15. For example, in 2005, over 90% of UK sales of pension products (in terms of APE)<sup>17</sup> and over 80% of unit trusts and OEIC gross retail sales<sup>18</sup> were sold through advisers. There are around 5,000 firms, primarily 'independent' financial advisers (see below), offering 'whole-of-market' advice in the UK. Such whole-of-market advisors account for more than 65% of total life product and pensions sales in the UK, and more than 75% of unit trust and OEIC sales.<sup>19</sup> In the UK, advisers are seen as the key conduit between consumers and products.<sup>20</sup>
16. Of the four largest European countries,<sup>21</sup> we believe that distribution of products via independent advisers is greatest in the UK. For instance, for life products,<sup>22</sup> France and Italy distribution channels are largely dominated by bancassurers. Of the four, only Germany has a mix, with brokers and tied agents leading this market.<sup>23</sup>
17. In June 2005 the structure of product distribution in the UK changed, as a result of the removal of restrictions that required advisers to be either independent (i.e. they searched the whole market for suitable products) or tied to a single product provider. The previous restrictions were known as "polarisation", and their removal is referred to as "depolarisation". 'Multi-tied' advisers are now permitted in the UK and the tag 'independent' is restricted to those 'whole-of-market' advisers who offer clients an option to pay a fee for their services. Furthermore, product providers can now own substantial stakes in advisory firms without the advisory firm being heavily restricted, as previously, in recommending their products. In order to ensure that this deregulation did not cause detriment to consumers, the FSA introduced some targeted disclosure requirements (the Initial Disclosure Document ("IDD") and Menu, which

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<sup>17</sup> Datamonitor, UK IFAs 2006 " The cake is getting bigger, but is everyone getting an equal slice?", August 2006, Table 3, percentage of the market expressed in APE (Annual Premium Equivalent).

<sup>18</sup> Datamonitor, UK IFAs 2006 " The cake is getting bigger, but is everyone getting an equal slice?", August 2006, Table 11, percentage of market expressed in terms of gross retail sales (£).

<sup>19</sup> Datamonitor, UK IFAs 2006 " The cake is getting bigger, but is everyone getting an equal slice?", August 2006, tables 3 and 11. See footnote 12 for life and pensions sales and footnote 13 for unit trusts and OEIC sales.

<sup>20</sup> In a March 2006 survey 68% of consumers said they would seek advice if they received an unexpected bequest to invest. Of those 68%, 43% said they would go to a bank for that advice, and 42% said they would go to an independent financial adviser. Source: Survey of consumer attitudes to finances and their experiences buying them, UK Financial Services Consumer Panel, March 2006, pp19-20.

<sup>21</sup> The UK is compared to other similar countries in terms of volumes. Together, UK, Germany, France and Italy accounted for 70% of the European life assurance market in 2004. Source: CEA, *The European Life Assurance Market in 2004*, Eco N. 22, March 2006.

<sup>22</sup> There is no reason to think that this is not the case for all financial products, considering the importance of life assurance. This is further confirmed when looking at the French market for financial products. 82% of investment funds and 62% of life products are sold via integrated banking groups. Source: Votre argent.fr, Réglementation, La distribution actuelle : "La commercialisation des produits financiers est dominée aujourd'hui par les grands réseaux proposant des produits maison", January 2006, available at: <http://www.votreargent.fr/banque/articles/article.asp?id=134898>

<sup>23</sup> CEA, *The European Life Assurance Market in 2004*, Eco N. 22, March 2006.

we do not intend to retain from 1 November 2007) to help clients understand the adviser's status and basis of remuneration.

18. So-called 'principal/agent' risks can arise from the way in which advisers are remunerated and fund their businesses in the UK market. Consumers in the UK are generally reluctant to pay an up-front fee for advice. This means that advisers and other intermediaries are frequently remunerated through commission paid by the product provider to the adviser/intermediary.<sup>24</sup>
19. The amount of commission paid is usually dependent on the choice of product. Therefore, whilst advice is of significant importance to UK consumers, their interests may not always be aligned with the interests of their advisers. Advisers can be influenced by personal financial considerations (i.e. how much commission they will receive) when making a recommendation to a consumer. This risk is exacerbated by most consumers' inability (without help) to assess the correct value of these products, as indicated above, or to appreciate the status of an adviser and how the firm is remunerated, or to request a rebate of part of the commission. Principal/agent problems can lead to risks of bias in the choice of product providers an adviser looks at (bias in selection of range) and in the recommendation made (driven by commission bias).
20. Examples of these risks crystallising in the UK market are the mis-selling of:
  - a) personal pensions: consumers who would have been better off in their employer's pension scheme were advised to opt-out or transfer-out in favour of a personal pension;<sup>25</sup> and
  - b) endowment policies to repay mortgages: consumers were not made sufficiently aware that there was no guarantee that the proceeds at maturity would be sufficient to repay the mortgage loan.
21. Though these two particular product types are outside MiFID scope, the underlying risks are just as relevant to in-scope markets and could crystallise for in-scope products in future. If regulators address the risks only for non-scope products they create a potential market distortion and incentive for the risks to crystallise in relation to MiFID scope.

## **Section 2: the requirements covered by this notification**

### **A - The accuracy of representations about the nature of the service offered**

22. The FSA has maintained provisions<sup>26</sup> requiring that if a firm advises retail clients in relation to packaged products, the firm may only hold itself out as 'independent' if it:

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<sup>24</sup> As anticipated by Recital 39 to the Level 2 Directive.

<sup>25</sup> This resulted in compensation payments of over £11.5 billion being paid to over 1.7 million consumers. See <http://www.fsa.gov.uk/Pages/Library/Communication/PR/2002/070.shtml>

<sup>26</sup> COBS 6.2.15R and 6.2.16R.

- a) advises on packaged products from the whole of the market (or the whole of a market sector) (the "**whole of market requirement**"); and
- b) offers its clients the opportunity to pay for the advice solely by fee and, if a client chooses to do so, transfers to the client the value of any commission received by the firm in respect of transactions in packaged products for that client (the "**fee option requirements**").

*In what way are the provisions additional to those in the Level 2 Directive?*

- 23. Articles 19(2) and (3) of the Level 1 Directive, together with the Level 2 provisions implementing these Articles, require firms to inform clients about their services in a way that is fair, clear and not misleading. The **whole of market requirement** above can be seen as an application of these principles to the way in which the concept of an independent adviser is generally understood in the UK packaged product market. Use of the term 'independent' in this context is only fair, clear and not misleading if it means that whole of market/whole of market sector advice will be provided. The effect of the requirement is not to create a distinct investment service of "independent investment advice", but to seek to ensure that a particular model of investment advice is correctly represented and understood. **However, the UK is notifying the whole of market requirement on a precautionary basis, in case it is deemed to impose additional requirements beyond the Level 2 measures implementing Article 19.**
- 24. The **fee option requirements** could be seen as going beyond MiFID by addressing the range of charging structures that 'independent' firms must offer in order for their claim of independence to be fair, clear and not misleading. However, the Level 2 provisions under MiFID Article 19 do not deal explicitly with the types of charging structures a firm must offer. There is therefore an argument that the fee option requirements should be seen as outside the scope of the Article 4 notification requirement and compatible with implementation of the Directive. **However, the UK has included these requirements in this notification on a precautionary basis, in case they are deemed to be within the scope of Article 4.**
- 25. The associated requirement for an 'independent' firm to transfer to a 'fee option' client the value of any commission the firm receives could be seen as related to the provisions on the acceptance of inducements in Article 26 of the Level 2 Directive. However, it is primarily another consequence of applying the principle that all communications with clients must be fair, clear and not misleading to the requirement to offer a fee option service. It would be misleading for a firm to accept and retain commission after agreeing to provide such a fee based service.

*What are the specific risks to (i) investor protection or (ii) market integrity that the requirements address that are not adequately addressed by the Level 2 Directive?*

- 26. The **whole of market requirement** addresses the risk that clients will be misled about the nature of the service they receive. The high level "fair, clear and not misleading" principle in Article 19(2) of the Level 1 Directive does not explicitly seek to address the particular circumstance of a firm describing itself as "independent". But if the principle cannot be applied to this situation in an effective and practical

way, then the risk of investors being misled remains. If the whole of market requirement is consistent with MiFID, as we believe, it still provides greater certainty for firms in the UK for the FSA to have a clear rule on this point.

27. The **fee option requirements** address the same risk of clients being misled, by a firm that claims to be independent but is still remunerated only by commission (i.e. the firm is not necessarily *financially* independent). The requirements allow a client to choose advice that is financially independent of the product provider as well as advice that covers products across the whole of the market. Although the Level 2 provisions under Article 19 do not deal explicitly with the types of charging structures a firm must offer, Recital 39 to the Level 2 Directive recognises the principle that the payment of commission to an adviser is only acceptable if it does not result in biased advice or recommendations. It can, though, be difficult to establish whether such bias has arisen, and the incentives that may lead to commission bias are powerful. So implementing the principle in Recital 39 in practice (alongside the principle of fair, clear and not misleading information) requires specific measures in order to be effective. Research carried out at the time of depolarisation<sup>27</sup> showed that there was scepticism that advice could be truly independent where the only form of remuneration was by commission. Encouraging the use of purely fee based advice is one of these measures, which the fee option requirements seek to do. The requirements thus seek to ensure that fee options are available in the market, that clients are made aware of this option, and that a fee based service is actually provided in practice if a client chooses it.

*In what way are the risks of particular importance in the circumstances of the market structure of the UK?*

28. Before the 'depolarisation' of the UK market in 2005 (see Section 1 above), the term "independent" was used to describe one of the two permitted distribution models and was a very important aid to consumer understanding of the service they were receiving. While other business models are now permitted in the UK packaged product market, the concept of independent advice retains a particular meaning in the relevant market, which we do not wish to see abused or misrepresented. Moreover, research which we carried out at the time of depolarisation<sup>28</sup> identified the risk of consumer confusion without a strict definition. This showed that consumers understood the concept of independent advice more easily than tied advice and that where an independent adviser was chosen, the adviser's status was a key factor. This objective is reflected in the **whole of market requirement**.
29. As described in Section 1, the level of commission-based advice in the UK market is very high and the consequences for clients of any mis-selling particularly significant. Encouraging the provision of services on a fee only basis (as the **fee option requirements** seek to do) should help to more closely align the interests of the firm and the client and address some of the risk of mis-selling.

*Why are the requirements proportionate?*

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<sup>27</sup> <http://www.fsa.gov.uk/pubs/consumer-research/CRPR09.pdf>

<sup>28</sup> <http://www.fsa.gov.uk/pubs/consumer-research/CRPR09.pdf>

30. The **whole of market** and **fee option requirements** apply only in relation to firms that advise retail clients on packaged products, to ensure that the requirements are focused on the products and situations in which the risks to investor protection are most likely to arise. They also only apply to firms that hold themselves out as 'independent', which means that firms are given the flexibility to operate their business on other models if they choose. It would still be possible for a 'whole of market' adviser to operate on a commission-only basis, outside the fee option requirements; it is just that the adviser could not call itself 'independent'.
31. At depolarisation, the FSA considered which firms, if any, were to be allowed to carry on using the term 'independent', taking account of (i) the burden to firms of imposing any restriction and (ii) the difficulty for consumers of educating themselves about what the new term meant. The FSA decided to carry forward its existing requirement that 'independent' firms should be whole of market, with the new requirement that a fee option be available. The FSA did not see the need to impose any further restriction as to ownership of firms in order for firms to call themselves independent.
32. In reinforcing the MiFID principle that firms must communicate in a manner that is fair, clear and not misleading, the **whole of market requirement** does not involve significant additional burdens for firms and is much less intrusive than the previous polarisation approach, which restricted the business models available to firms.
33. The **fee option requirements** are a proportionate response to the risks identified because they do not prevent firms from also offering alternative remuneration structures (such as commission only). They only apply where a firm chooses to call itself 'independent'. Also, where the requirements do apply, they give firms the freedom to set their own fee rates. The maintenance of these requirements is therefore a much less restrictive approach than banning the acceptance of commission or prescribing particular fee rates. It delivers choice for clients, and should give them reassurance that they can get advice free of the risk of commission bias, if this is what they want. The approach should also (particularly when combined with other disclosure requirements described below) encourage competitive pressures on commission rates, improving overall investment performance.

*Do the requirements restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC?*

34. The requirements will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive. This is because the FSA will not apply them to firms exercising rights under Article 31 and will only apply them to firms exercising rights under Article 32 in the circumstances contemplated by Article 32(7).

## **B - Information about products**

35. The FSA has retained specific requirements relating to the provision of certain information on packaged products at the point of sale and in a particular form.<sup>29</sup> With

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<sup>29</sup> COBS 14.2.

some exceptions,<sup>30</sup> the FSA requires intermediaries to provide retail clients with core product information, in the format of a simplified prospectus for UCITS, and either a simplified prospectus or a "key features" document for other packaged products.

*In what way are the provisions additional to those in the Level 2 Directive?*

36. The Level 2 measures implementing Article 19(3) of the Level 1 Directive impose a number of requirements on firms concerning information to clients.

#### UCITS schemes

37. In the case of UCITS schemes, Article 34 of the Level 2 Directive deals with the extent to which a firm can satisfy the information requirements relating to the UCITS and its fees and charges by providing a copy of a simplified prospectus complying with Article 28 of the UCITS Directive.<sup>31</sup> The wording of that provision is unclear as to whether the provision of a simplified prospectus is the only way in which a firm can discharge those information requirements or one of a number of ways in which it may do so.
38. Under the FSA's implementation of the UCITS Directive, it generally requires any firm that sells, personally recommends or arranges a sale of units in a UCITS to offer a copy of the simplified prospectus before conclusion of the contract. Article 33(1) of the UCITS Directive provides that a copy of the simplified prospectus must be offered to subscribers free of charge before the conclusion of the contract. The Directive is silent as to who must offer this, but where the UCITS is distributed by an intermediary the offer will in practice need to be made by the intermediary, because the UCITS and its manager are unlikely to have direct contact with the client before the conclusion of the contract.
39. However, where a firm sells, personally recommends or arranges a sale of units in a UCITS established in the UK to a retail client, the FSA requires that firm to actually *provide* (not just offer) a copy of the simplified prospectus to the client and to do so in good time before the firm provides the investment service.<sup>32</sup> In the way that they specify actual provision of the document, these FSA requirements may be seen as going beyond the provisions of the MiFID Level 2 Directive that implement Article 19(3) of the Level 1 Directive, and also go further than Article 33(1) of the UCITS Directive. However as the position is open to some degree of interpretation **this notification is provided on a precautionary basis.**

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<sup>30</sup> See paragraph 54.

<sup>31</sup> COBS 14.3.11R, which was made in policy statement PS 07/06 [http://www.fsa.gov.uk/pubs/policy/ps07\\_06.pdf](http://www.fsa.gov.uk/pubs/policy/ps07_06.pdf).

<sup>32</sup> COBS 14.2.1R, COBS 14.2.5R and COBS 14.2.9R set out certain exemptions from the requirements to *provide* the key features document/simplified prospectus. COBS 14.2.4R contains a rule that is designed to ensure that firms selling packaged products produced by another firm do not mislead their clients as to the identity of the producer of the product. This is in effect a specific application of the general requirements concerning fair, clear and not misleading communications in and under Article 19(2) of the Level 1 Directive. It therefore does not impose any additional requirements for the purposes of Article 4 of the Level 2 Directive.

40. These FSA requirements have a broader scope than MiFID. Where the firm selling/recommending the UCITS scheme is the manager of the scheme, it will be exempt from MiFID under Article 2(1)(h) of the Level 1 Directive. Many intermediaries will also fall within the exemption in Article 3 of that Directive. But where the firm is an intermediary that is not exempt from MiFID, the requirements could be seen as going beyond the Level 2 provisions implementing Article 19(3) in the specific respects mentioned.

Non-UCITS schemes ("key features schemes")

41. The schemes that the FSA refers to in its rules as "key features schemes" are collective investment undertakings that may be marketed to the public in the UK but fall outside the UCITS directive. These are a relatively narrow category of investment funds<sup>33</sup>, which are broadly equivalent to UCITS schemes but do not meet the criteria for recognition under the UCITS Directive (for example, because they invest in real estate or because they are established in non-EEA jurisdictions) or because they are established as investment trusts.
42. In order to be marketed to the public in the UK, these schemes must comply with a national authorisation requirement, which falls outside of the scope of MiFID (by definition they cannot take advantage of the UCITS passport). In view of this national authorisation requirement, the requirement to provide a copy of the key features document is unlikely to have a significant incremental effect on these schemes' access to the UK market.
43. In order to ensure that adequate information is available about key features schemes, the FSA requires a key features document to be prepared by the product provider. This is broadly equivalent to the simplified prospectus that must be prepared for a UCITS scheme.<sup>34</sup> In addition, in the case of key features schemes, FSA rules give firms the option to produce a document based on the simplified prospectus instead of the key features criteria, if they wish<sup>35</sup> - and many firms do so. The FSA then requires a copy of the key features document (or simplified prospectus, as appropriate) to be provided to the client where the scheme is sold to a retail client.<sup>36</sup>
44. As with the disclosure requirements for UCITS, these requirements have a wider scope than MiFID. Where the firm selling/recommending the key features scheme is the manager of the scheme, it will be exempt from MiFID under Article 2(1)(h) of the Level 1 Directive. Many intermediaries will also fall within the exemption in Article 3 of that Directive.

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<sup>33</sup> The requirement is not relevant to products that are not funds. For example, it does not apply to structured products.

<sup>34</sup> The requirements concerning the contents of the key features document are set out in COBS 13.3, which was made in policy statement PS 07/06 [http://www.fsa.gov.uk/pubs/policy/ps07\\_06.pdf](http://www.fsa.gov.uk/pubs/policy/ps07_06.pdf).

<sup>35</sup> COBS 14.2.7R.

<sup>36</sup> COBS 14.2.1R.

45. However, where the firm selling the key features scheme is an intermediary that is not exempt from MiFID, the requirement to provide a copy of a key features document (or simplified prospectus) could be seen as going beyond the Level 2 provisions implementing Article 19(3) of the Level 1 Directive, since it is prescribing the particular document to be used for the provision of information.

*What are the specific risks to (i) investor protection or (ii) market integrity that the requirements address that are not adequately addressed by the Level 2 Directive?*

46. The principal risk is related to information asymmetry in a market where (as we have explained) there is a particular need for comprehensible information to be readily available to clients. Past experience in the UK market indicates that the standard and quality of information provided to clients would be uneven and inconsistent without an obligation to provide prescribed information in a relatively standard form<sup>37</sup> (and of reasonable quality) through either a simplified prospectus or a key features document, as relevant. Furthermore, extensive FSA research shows that the presentation of disclosure material will enhance its effectiveness; with factors such as the clarity and look of the layout affecting the likelihood of readers to engage with the information. The research shows that UK consumers are more likely to read information laid out in a clear and succinct manner, for example in a Q&A format.<sup>38</sup> The FSA has also tested a number of formats for presenting charges and projections and found that consumers prefer standardised tables.
47. The FSA's approach also seeks to minimise the risk of inconsistency and lack of comparability between substitutable products in the market. The UCITS product disclosure regime is prescribed by the UCITS legislation. Through the degree of alignment between the simplified prospectus and key features documents, and the need to provide them to clients, the FSA approach aims to improve consistency on these matters across both products harmonised at EEA level and substitutable products that are not harmonised at EEA level and which are subject to national authorisation requirements. Otherwise, there is also a risk that clients would find it harder to compare such products or that unharmonised products would benefit from a market distortion (because they are subject to a less prescriptive regime than UCITS).
48. This is particularly important because a key element of the simplified prospectus (also employed in the key features document) is the standardised disclosure of the effects of charges. Without a requirement actually to provide a copy of this document, it is possible that this disclosure would not be made to many clients. This would reduce the scope for price comparison, possibly leading to increased charges in the market. It might also have the effect of reducing competition in the packaged product market.
49. We also believe that requiring advisers actually to hand over standardised product information has a disciplining effect on their recommendations, since it exposes them to the risk that the client will use the documents to verify what they have been told (including by comparing it to information from other advisers and product providers).

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<sup>37</sup> "Relatively standard" because the FSA requirements do not prescribe the full detail of a totally uniform text.

<sup>38</sup> H2b: KFD Development. H2b: Taking forward the KFD. See FSA Consumer research 18 <http://www.fsa.gov.uk/pubs/consumer-research/crpr18.pdf>

If a client actually has such documentation in his/her possession, it also puts the client in a better position to question any points or to seek redress if necessary.

*In what way are the risks of particular importance in the circumstances of the market structure of the UK?*

50. Once again, the key points are that UK consumers rely more heavily on intermediaries than in other Member States, that UK advisers are more likely to be remunerated by commission from the product provider (with potential misalignment of interests), and that the consequences of a wrong decision are particularly significant for UK consumers who may rely on the savings to fund retirement. These factors are further explained in section 1 above.
51. In addition, the particularly wide variety of funds and other packaged products available to UK retail clients makes it especially important that consumers be given standardised product information of a reasonable quality - to help them better understand the nature of sometimes quite complex products, and help them make comparisons. By way of illustration, in just one category of funds on sale in the UK at the moment,<sup>39</sup> there are over 180 funds, each of which could be packaged for consumers in a number of different ways (including, for example, as funds of funds or inside an ISA wrapper). Standardised disclosure of core information in a comparable form across these different fund packages thus becomes particularly relevant.

*Why are the requirements proportionate?*

52. We believe that the FSA requirements constitute a low-cost approach to providing clients with key standard information they need, to a reasonable quality and in a sufficiently consistent and comparable form.
53. Since the UCITS Directive requires the product provider to produce a simplified prospectus and, in practice, in a normal sales scenario involving an intermediary the intermediary would have to provide it anyway, the marginal cost of *requiring* the intermediary to provide it to clients is modest. Provision of a simplified prospectus will also allow the firm to demonstrate it has complied with its obligations under Article 19(3) second tiret of the Level 1 Directive. The same arguments apply in respect of key features schemes.
54. The FSA has also sought to apply the requirements in a proportionate manner by taking account of different business models and distribution methods. For example, in direct sales marketing, the FSA will require the provision of materially the same information but not necessarily separately in the key features document or simplified prospectus format.<sup>40</sup> If firms prefer, they can use this flexibility to supply the information in different documents and at different times. In addition, where clients act on their own initiative, the rules provide an exemption from the need to provide

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<sup>39</sup> The Investment Management Funds "UK all companies" classification in the FSA Comparative Tables, <http://www.fsa.gov.uk/tables>, as at 12 October 2006.

<sup>40</sup> COBS 14.2.5 R (4). The obligation on firms to offer a simplified prospectus compliant with Article 28 of the UCITS Directive would still apply, however.

either document.<sup>41</sup> In this way, the FSA requirements focus the obligation on circumstances where information asymmetries and incentives on firms are likely to pose the greatest risks.

*Do the requirements restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC?*

55. The requirements will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive. This is because the FSA will not apply them to firms exercising rights under Article 31 and will only apply them to firms exercising rights under Article 32 in the circumstances contemplated by Article 32(7).

**C - Information about the costs of services (hard disclosure of commission and commission equivalent)**

56. The FSA has retained certain requirements relating to the disclosure of actual commission and commission equivalent. The disclosure of actual commission and commission equivalent support the MiFID provisions concerning the acceptance of inducements and the risk of commission bias and are consistent with the approach of allowing the essential elements of arrangements relating to inducements to be disclosed in summary form.<sup>42</sup> It could be argued that they are in fact a more specific form of implementation of those requirements. However, **the UK is notifying them on a precautionary basis.**

*In what way are the provisions additional to those in the Level 2 Directive?*

57. The FSA requires a firm that sells, personally recommends or arranges the sale of a packaged product to a retail client to disclose the following information on commission (the "**requirement to disclose hard commission or commission equivalent**"):<sup>43</sup>
- a) any commission receivable by the firm or any of its associates in connection with the transaction; and
  - b) if the firm or any of its associates is in the same immediate group as the product provider, any "commission equivalent" in connection with the transaction;

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<sup>41</sup> COBS 14.2.8 R and COBS 14.2.5(4)(b).

<sup>42</sup> Article 26 of the Level 2 Directive, see COBS 6.4.3R.

<sup>43</sup> COBS 6.4.3R.

- c) if the firm is also the product provider, any commission or commission equivalent payable in connection with the transaction.<sup>44</sup>
58. The requirement for the disclosure of commission equivalent is relevant where an intermediary and a product provider are in the same immediate group. In such cases, some product providers in the UK market have, in the past, used non-cash transfers (such as the provision of office facilities, administrative and compliance support and loans on favourable terms) to remunerate affiliated intermediaries and therefore avoided the requirement to disclose the payment of cash commission. In order to achieve an appropriate degree of comparability to ensure disclosures are effective, it is necessary where there is no commission as such (e.g. a salaried adviser in a bank) to define how to calculate a "commission equivalent". The rules on commission equivalent require the firm to calculate the value of such non-monetary benefits, and disclose it in the place of (or where relevant in addition to) any commission in the form of cash payments.<sup>45</sup>
59. The requirement to disclose hard commission or commission equivalent deals with benefits passing from the product provider to the intermediary, rather than payments of fees from the client to the firm. It is therefore most closely related to the requirements concerning the acceptance and disclosure of inducements under Article 26 of the Level 2 Directive – although the provision of commission equivalent may involve the movement of benefits to another member of the firm's group as opposed to the provisions of benefits directly to the firm. It builds upon the requirements of the Level 2 Directive by making it clear that the disclosure of the essential elements of the arrangements in this market should include actual amounts (in the case of commission) or amounts referable to the size of the relevant transaction (in the case of commission equivalent). It also requires the disclosure to be made in relation to each transaction and also, at a later date if requested by the client.<sup>46</sup> However, as noted above, we believe that taking account of the circumstances of the relevant market, these requirements are consistent with the approach of allowing the essential terms of the arrangements to be disclosed in summary form.
60. The FSA has also maintained a requirement<sup>47</sup> that restricts circumstances in which commission can be paid other than to a firm responsible for the sale. The restriction seeks to close a potential loophole by preventing firms from artificially reducing the level of commission they have to disclose by directing part of this to another person (possibly an unregulated associate). It is therefore a supporting element of the requirement to disclose hard commission or commission equivalent. There are a number of exceptions to this restriction to allow for legitimate situations in which: (i) the firm responsible for providing advice has passed on its right to receive the

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<sup>44</sup> This third requirement will generally not be relevant for MiFID scope firms because of the exemption in Article 2(1)(h) of the level 1 Directive, although it may occasionally be relevant for firms offering investment trust savings schemes.

<sup>45</sup> COBS 6 Annex 6E contains detailed provisions dealing with the preparation of commission equivalent figures. See also COBS 6.4.6E.

<sup>46</sup> COBS 6.4.3R.

<sup>47</sup> COBS 6.4.7R.

commission to another (since the adviser was originally entitled to the commission it will still have to be disclosed); (ii) another firm provides advice, or passes on a financial promotion, for which it will be entitled to be remunerated; or (iii) the transaction takes place between firms in the same immediate group (in which case commission equivalent will be calculated instead).

*What are the specific risks to (i) investor protection or (ii) market integrity that the requirements address that are not adequately addressed by the Level 2 Directive?*

61. MiFID contains different levels of detail concerning the disclosures that must be made in relation to fees paid directly by the client and commissions paid to intermediaries by product providers. In particular it does not provide any detail as to the way in which the upfront disclosure of the essential elements of inducements should be made. As we have explained, in the UK retail market for packaged products there is direct competition between firms remunerated solely on fees from the client, firms remunerated by the payment of cash commissions (usually from unconnected product providers), firms remunerated by non-cash benefits (usually from connected product providers), and firms remunerated on the basis of a combination of the above.
62. If a standardised approach to disclosing these various options (and their value to the firm) is not adopted, clients may be led to believe incorrectly that firms that are remunerated on a commission or commission equivalent basis offer a cheaper service than firms remunerated on a fee basis (or that firms remunerated on a commission equivalent basis offer a cheaper service than those remunerated on a cash commission basis). This would create a false competitive advantage for commission (or commission equivalent) based services over fee based services. Such a competitive distortion would be damaging to the interests of consumers in the light of the incentives that commission based remuneration creates and the attendant risk of commission bias. These risks mean that the essential elements of the arrangements to be disclosed may be different than those that may be required in other contexts.
63. Reliance solely on pure copy out of the MiFID disclosure requirements is best suited to cases in which only one remuneration model is offered to the client. In contrast, as this paper has explained, one of the aims of the FSA's packaged product regime is to encourage the provision of alternative payment options. The requirement to disclose hard commission or commission equivalent is designed to help the client understand the benefits that will accrue to the intermediary in the context of an actual transaction and to work across the different business models operating in the UK market. This transparency about the essential elements of commission levels creates a market discipline that helps to counteract the risk of commission bias. It is consistent with, and (like other requirements described in this notification) reinforces, the approach outlined in Recital 39 of the Level 2 Directive, that commission payments should only be seen as designed to enhance the quality of the service to the client if the advice is not biased as a result.

*In what way are the risks of particular importance in the circumstances of the market structure of the UK?*

64. The fact that intermediaries in the UK market are frequently remunerated through commission or commission equivalent increases the risk of biased advice when

compared to a fee based service. The requirements relating hard disclosure of commission and commission equivalent are an important element of the FSA's measures to mitigate this risk. This risk has increased in the UK since depolarisation. It is particularly significant if an adviser sells the products of a number of product providers without offering an independent (whole of market) service. This is because the adviser may have an incentive to select the range of products they consider on the basis of the level of commission payments different providers are willing to pay.

65. If the requirement were disapplied only for MiFID scope products there would be a considerable risk of market distortion because of the degree of substitutability of scope and non-scope packaged products, the competition between scope and non-scope intermediaries and the competing remuneration structures of firms in the UK market.

*Why are the requirements proportionate?*

66. The requirements are proportionate as they deal with the particular risk of product bias that exists in the UK market. Possible alternatives to the hard commission disclosure rules are generic disclosure and a ban on commissions higher than a certain monetary amount or percentage.
67. It is unlikely that a disclosure in generic, rather than client-specific, terms would be effective in encouraging clients to request commission rebates in relation to particular sales. It is also unlikely that generic disclosure would have a disciplining effect on advisers. Before we introduced the current rules we had a maximum commission-based regime. However this restrictive approach was considered to be potentially anti-competitive and was removed in 1989.

*Do the requirements restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of Directive 2004/39/EC?*

68. The requirements will not restrict or otherwise affect the rights of investment firms under Articles 31 and 32 of the Level 1 Directive. This is because the FSA will not apply them to firms exercising rights under Article 31 and will only apply them to firms exercising rights under Article 32 in the circumstances contemplated by Article 32(7).