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RDR – A CONCISE GUIDE TO THE RETAIL DISTRIBUTION REVIEW

EXECUTIVE SUMMARY

The RDR represents regulatory reform of strategic importance that is unique to the UK. It is due to be implemented on 31st December 2012. Despite its title, it is concerned specifically with retail investments although it has also spawned separate reviews of both the pure protection and mortgage markets. The RDR specifically covers the advised sale of all packaged products including pensions, annuities, onshore and offshore bonds and collective investments. Undoubtedly, the RDR will require fundamental changes in operating models at all levels impacting on both product providers and adviser firms. The FSA sees the RDR principally being about 'improving outcomes for clients' but it is also committed to far greater product intervention. It is clear that the retail investment market is to be subject to intensive and prescriptive regulation.

The RDR was announced in June 2006 and since this time the FSA has published a whole series of consultation and discussion papers on a range of related topics. The goals of the RDR are well known:

- increase the professional standards of all investment advisers;
- improve the clarity with which firms describe their services to consumers;
- address the potential for commission to distort consumer outcomes;
- improve the sustainability of the market.

Several countries have similar reviews underway and indeed a ban on the payment of commission already exists in Norway and Finland and will be introduced in Australia (2012) and the Netherlands (2013). Against a background of miss-selling scandals and very evident commission-bias, the FSA shares with these countries a view that current retail investment market is not 'fit for purpose'. They also believe that greater transparency will be central in helping to rebuild consumer trust.

The final rules for key strands of the RDR reforms (adviser charging, scope of service and professionalism) are already in place following the publication of Policy Statements PS10/06 and PS11/1 both entitled "Delivering the RDR". That being said many bodies, including the Treasury Select Committee, believe more time is required to deliver the RDR reforms effectively. Others fear excessive regulatory cost and rule duplication as the EU is also engaged on a similar programme with PRIPs (or Packaged Retail Investment Products) but with different features and, importantly, timetable. Planned EU updates of the existing MiFID and IMD (the so called MiFID-2 and IMD-2) may well be maximum harmonization directives leaving little within their scope for national variation. However, the FSA remains committed to the RDR timeline and believe the latest MiFID-2 text will pose no insurmountable issues although the proposed European rules differ over the definition of advisor "independence".

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THE RDR IN A NUTSHELL:

- Commission will be banned on all advised investment sales.
- Product providers must introduce new operating models eliminating commission payments for retail investment products sold on an advised basis.
- Advisers can offer an 'independent' or 'restricted' service to their retail clients.
- Advisers must set their own charges for any advice given with no involvement of product providers.
- An independent adviser must offer a comprehensive review of all retail investment products and act in the client's best interests.
- Commission remains payable on non-advised sales.

Commentators have consistently informed the FSA that the planned RDR rule changes will result in investment advice becoming solely the province of the HNW. In a post-commission world the ABI has estimated that the average cost of advice to be £670 (ABI Research Paper No.22) thought to be well beyond the reach of the typical middle or mass market client. Implementing a suitable adviser charge is considered by many observers to be the most challenging element of the RDR.

The FSA published a guidance consultation on 'Simplified Advice' in September 2011 essentially promoting the existing 'basic advice' or 'focused advice' as a means to deliver a lower cost advice service. It is hoped that the new Money Advisory Service (or MAS) will deliver suitable consumers seeking a specific product need. Although the FSA has been very reluctant to engage in any simplified regime (eg insisting that all advisers are fully QCF level 4 qualified) HM Treasury has championed the subject and issued a number of closely related consultations on simple products. A new steering group will report back to the

Treasury by July 2012. It is likely initially to focus on simple deposit savings and protection insurance products but somewhat inevitably investment products for long-term savings will also be within scope. A cost-effective advice process for the mass market that offers an economic return to advisory firms is an essential outcome and requirement for the RDR. Sadly, we are no nearer a satisfactory low cost advice process than when the RDR was launched in 2006.

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INTRODUCTION

The FSA's final rules focus on improving the clarity of consumer disclosure regarding the type of retail investment advice on offer and also tackle head on the potential detriment caused by commission bias.

In summary:

- Firms must describe their advice service as either 'independent' or 'restricted'.
- Firms providing independent advice will be expected to conduct a comprehensive and fair analysis on a wider range of retail investment products. They must always act in the consumer's best interests.
- The definition of retail investment products is similar to the European PRIPs including structured investments but excluding structured deposits.
- The FSA will introduce 'Adviser Charging' which will involve all firms that give investment advice to retail clients setting their own charges with definitively no involvement of product providers.
- Adviser firms will no longer be able to receive commissions set by product providers in return for recommending their products.
- Product providers will be able to facilitate the collection of adviser charges through the product on a matched basis but only if they wish to do so.
- There is to be no factoring of adviser charges by product providers.
- Revised rules and guidance on inducements will curtail the potential of 'soft commissions' to circumvent the new regulations.
- Adviser charging will not apply to non-advised services where investment sales can continue to earn commission.

ADVISER CHARGING

The RDR will introduce '**Adviser Charging**' requiring all firms that give investment advice to retail consumers setting their own charges. Of critical importance, the adviser firm will no longer be able to receive commission from the product provider in return for recommending their products. Product providers can if they so wish facilitate the collection of adviser charges through the product but only on a matched basis.

Despite earlier proposals product providers will no longer be required to monitor the level of Adviser Charges. They must, however, have clear instructions from the client if they facilitate an advice charge. In reviewing future income streams it is important to recognise that product providers will not be allowed to factor an adviser's charge for regular or single premium business. For group pension schemes charges for advice will be termed 'Consultancy Charging'.

Allocation rates over 100% will also be banned to help clarify charging structures.

Vertically integrated firms (eg Bancassurers) will be required to adopt Adviser Charging. The FSA will consult on adding detailed guidance to their Handbook regarding charge calculation in such circumstances. In terms of discretionary investment management if a personal recommendation is made Adviser Charging must be adopted. Conversely, if no personal recommendation then the new Advice Charging requirements will not apply.

If an adviser firm recommends that their retail client invests through a specific discretionary manager then this discretionary manager cannot pay commission to the original adviser for the

recommendation. Any firm providing advice on a stakeholder product, except through Basic Advice, will be required to meet the Adviser Charging rules.

The FSA recognises that firms may attempt to avoid Adviser Charging by mislabeling their services as non-advised. The new rules state that if executing a transaction which has been recommended by either the same firm or another with which it is associated, it must apply Adviser Charging.

THE SCOPE OF SERVICE

The RDR will introduce two different types of advice – independent and restricted. From 31 December 2012, advisers (excluding those who recommend securities and derivatives) will have two choices. They must offer either totally independent advice from across the whole market, or restricted advice.

INDEPENDENT ADVICE:

The final RDR rules introduce major changes for "independent advice".
Independent advisers must:

- Conduct a comprehensive and fair analysis of the relevant market.
- Select a product only if in accordance with the client's best interest rule.

The FSA do not expect independent advisers to review products not available to, or targeted at, UK consumers. A firm can recommend their own or a parent company's products only if they meet the FSA's unbiased and unrestricted analysis requirements. If an adviser is given a greater reward for recommending a firm's own product ahead of others in the marketplace then this will <u>not</u> meet the FSA's unbiased standards.

Importantly, independent advisers can continue to use panels. However, they must be able to demonstrate clearly why it believes a particular market, product or class of products, which have been excluded, are not suitable for their client's needs. Such panels must be regularly reviewed. If a firm limits advice to certain products (eg pensions), this is a form of restricted advice and this type of service cannot be labeled as independent.

RESTRICTED ADVICE:

- All advice which is not independent is to be termed "restricted".
- Restricted advisers will not be required to use mandated wording to disclose the nature of their service and they must develop their own set of words and disclosure documentation to reflect their business model.
- Restricted advisers must disclose orally to their client that they provide a restricted advice service and the nature of that restriction.
- All advisers (restricted & independent) must attain the QCF level 4 qualification.

It is important to recognise that restricted advice:

- is still advice
- must be suitable for the client

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- is subject to the adviser charging rules
- must still meet the new professional standards
- In addition to the written disclosure, an oral description of the nature of the restriction must also be provided. The oral disclosure must precede the advice process.

The latest FSA information (October 2011) indicates that 71% of existing IFA firms will remain independent, 4% will offer a restricted service, 4% will offer both and 21% have yet to decide.

The FSA proposes amending the existing templates for the Services and Costs Disclosure Document (SCDD) and the Combined Initial Disclosure Document (CIDD) so that firms who wish to use these documents will be able to satisfy the new written disclosure requirement by completing the document in line with the notes.

PROFESSIONALISM

Globally regulators have acknowledged that consumers simply do not have the same information as the advisers providing the products. The purchase of retail investments requires consumers to make relatively complex decisions that many may not fully understand. This situation is exacerbated, of course, as financial capability is in its infancy in the UK. The FSA hopes that the RDR will help rebuild trust in the financial services industry and, in particular, build a body of professional advisers in whom the public can trust.
From December 2012, every adviser (including those who recommend securities and derivatives) will have to meet new consistent professional standards. The FSA is introducing an overarching code of ethics for investment advisers, ensuring they act with integrity and treat customers fairly.

The final rules on professionalism include requirements for:

- QCF level 4 qualifications (equivalent to year 1 in university) and gap fill
- Continuing Professional Development (better known as CPD)
- Accredited bodies

The FSA confirmed in PS10/18 and PS11/1 the list of qualifications appropriate for each type of retail activity. If advisers do not wish to take the examination route, there are alternative routes to obtain the appropriate qualification. Unqualified advisers will not be permitted to operate in the industry.

The FSA published PS11/1 ‘Distribution of retail investments: Delivering the RDR - professionalism’ in January 2011. This policy statement confirmed that all retail investment advisers will need to hold a Statement of Professional Standing (SPS) if they want to give independent or restricted advice after January 2013.

The SPS will provide customers with evidence that the adviser subscribes to a code of ethics, is qualified, and has kept their professional knowledge up to date.
The SPS will be issued by FSA accredited bodies which satisfy the following criteria:

- they act in the public interest and further the development of the profession.
- they carry out effective verification services.

- they have appropriate systems and controls in place and provide evidence to the FSA of their continuing effectiveness; and
- they cooperate with the FSA on an ongoing basis.

PS11/1 also sets out a requirement for investment advisers to complete at least 35 hours of Continuing Professional Development (CPD) each year, at least 21 hours of which must be structured (eg courses, lectures, seminars or workshops). All CPD has to focus on demonstrable change to improve advisers' skills and knowledge. The FSA will start collecting information about individual advisers with effect from January 2013 (eg qualifications, accredited body).
In preparation for 2013, the first of the Professionalism rules came into force in July 2011. Adviser firms are now obliged to notify the FSA if any adviser falls below the required standard of competence or ethical behaviour.

The FSA has recently consulted on RDR accredited bodies in CP11/11 QCP (Quarterly Consultation Paper) Number 29 issued in June 2011. It confirmed six accredited bodies have applied to the FSA although more are expected to be added to the list in due course:

- CFA Society of the UK;
- The Chartered Institute for Securities and Investment;
- The Chartered Institute of Bankers in Scotland;
- The Chartered Insurance Institute;
- The Institute of Financial Planning; and
- The Institute of Financial Services.

PLATFORMS

The original RDR discussion paper DP07/1 published in June 2007 was followed almost immediately by DP07/2 concerning platforms. Since this time the FSA has recognized the growing importance of the platforms market in the UK and has feared that their increased use might negate the key RDR reforms. Following CP10/29 "Delivering the RDR and other issues for platforms and nominee-related services" covering re-registration, capital adequacy, and providing information after point of sale) a policy statement PS11/9 was released in August 2011.

The rules published in PS11/9 partly extend the consumer protection elements of the RDR into investment services provided through platforms and must be implemented accordingly on 31st December 2012. PS11/9 has disappointed the industry as it has failed to address the treatment of legacy assets in the post-RDR world.

The FSA states that the new platform rules have two basic aims:

1. To ensure that consumers receive a better service.
2. For the market to be more transparent and operate more efficiently.

The key rules designed to provide better service for consumers:

- Require platforms and other nominee companies to transfer, within a reasonable time, assets held on behalf of customers to another person or firm when requested.
- Require platforms and other nominees to pass on fund information to the end investor.

The FSA will introduce new definitions for platform service and platform service provider. Services that the industry tends to refer to as fund supermarkets and wrap platforms will be included as a 'platform service'.

Definitions:

- Platform service: A service which
    - involves arranging and safeguarding and administering assets; and
    - distributes retail investment products which are offered to retail clients by more than one product provider;
- but is neither:
- (c) solely paid for by adviser charges; nor
- (d) ancillary to the activity of managing investments for the retail client.

Platform service provider: a firm providing a platform service.

To enable greater transparency and operational efficiency in the market, the rules:

- require investment adviser firms using a platform service for the purposes of making a personal recommendation (or arranging the purchase of retail investment products for retail clients) "to take reasonable steps to ensure that
- they use platforms services that present their retail investment products without bias".
- require platforms to disclose to professional and retail clients any fees or commission they arrange to accept from third parties in relation to retail investment products. In should be noted that these should be disclosed in advance of the platform providing services to those clients.
- extend the application of the RDR rules on facilitating payment of adviser charges to facilitation through platforms. This is especially so if a platform has client cash accounts.
- require nominees to respond to information requests by authorised fund managers specifically for liquidity purposes.

Suitability, Independent Advice and Incentives:

The key point for advisers choosing a platform to provide services to their clients will be suitability. The use of a platform has to be in the client's best interests and lead to suitable advice. The RDR rules state that a firm can only hold itself out as independent if it is offering advice which is unbiased and unrestricted, and based on a comprehensive and fair analysis of the relevant market. The FSA has issued guidance on good and bad practice (annex 5 CP10/29).

In respect of incentives, the FSA has commented that in principle it would be highly desirable to ban both cash rebates from product providers to investors and product provider payments to platforms. However, fearing the law of unintended consequences, the FSA has concluded that further research is needed before this step is taken as it might prove to consumer detriment. This research will not be completed before December 2012.

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IMPROVING THE SUSTAINABILITY OF THE MARKET

This is, of course, a key goal of the RDR. Fundamentally, the FSA believe that the ban on the payment of commission should improve the persistency of products. There are, however, also issues about the sustainability of advisory firms.

Smaller advisers are currently only required to hold £10,000 of capital. From the end of 2013 all personal investment firms (PIFs) will be required to hold capital which is the higher of £20,000 and a three-month expenditure-based requirement. Sadly, there has been an increase in the number of complaints relating to firms that have gone into liquidation. As the complaints cannot be addressed by these firms the consumer must seek recourse from the compensation scheme funded by the remaining advisory firms. Increasing capital standards should ensure more economically viable enterprises with less reliance on the compensation scheme.

OTHER ISSUES

1) PURE PROTECTION

Following publication of PS10/13 'Pure protection sales by retail investment firms' new rules will be introduced effective 31st December 2012 requiring firms to make a judgement about whether a pure protection transaction is associated with investment advice. At present ICOBS allows firms to elect to sell pure protection contracts under COBS. Under the current rules, this has the effect that ICOBS does not apply, and the firm must treat the pure protection contract as a life policy and a designated investment.

Under the new rules, firms can continue to elect to sell pure protection contracts under COBS rather than ICOBS. However, the relevant rules in ICOBS have been amended to take the new RDR rules on remuneration transparency into account.

Firms will not have to apply the Adviser Charging rules to pure protection sales. However, where pure protection advice is associated with investment advice, advisers will have to explain how they are remunerated and disclose the amount of commission they will receive.

2) COMMISSION ON EXISTING PRODUCTS

Commission can continue to be received on a product set up before the end of 2012 only if the product remains unchanged. If it is subsequently amended effectively becoming a different product then the new Adviser Charging rules will apply. Firms should not seek to renegotiate the commission payable nor seek to impose an Adviser Charge for a service that has already been paid for through commission.

3) SIMPLIFIED ADVICE

The FSA will not be creating a new simplified advice regime. This decision may have been taken due to lack of manpower and/or expertise but the industry has also been slow in developing their own ideas for a simplified process. An unwilling regulator and fear of the FOS has not helped! However, many commentators have expressed extreme disappointment that the RDR has not provided a proportionate advice regime for non-HNW customers. A particular stumbling block is the current FSA requirement for a fully qualified QCF level 4 seller even if a simplified advice process is adopted.

The FSA published a guidance consultation on 'Simplified Advice' in September 2011 essentially promoting the existing 'basic advice' or 'focused advice' as a means to deliver a lower cost advice service. It is hoped that the new Money Advisory Service (or MAS) will deliver suitable consumers seeking a specific product need. Subsequently at the ABI Conference on 'Simplified Advice' held on 20th October 2011, which largely revisited much old ground, it was announced that Mark Hoban, Financial Secretary to the Treasury, is to create a new steering group tasked '*with devising a suite of 'simple' financial products that will help consumers navigate the financial services market'*. This steering group will be chaired by Carol Sergeant (former Chief Risk Officer, Lloyds Banking Group). It will report back by July 2012 setting out how to bring simple products to market, including how simple products are structured and marketed to ensure that '*consumers get the best deal'*. Responses to the latest HM Treasury CP indicate that the group should initially focus on simple deposit savings and protection insurance products but it seems likely that investment products for long-term savings will also be included. A cost-effective advice process for the mass market that offers an economic return to advisory firms is an essential outcome and requirement for the RDR.

Both the FSA and HM Treasury have stated with simple products and simplified advice that they will not be part of any approval process. Early ideas talk of a kite mark but who will award this accreditation? Sadly, it appears we are no nearer a satisfactory low cost advice process than when the RDR was launched in 2006.

Basic Advice:
A surprise survivor of the RDR is 'basic advice'. This simplified advice process was introduced in 2005 for the sale of stakeholder investment products. Its use to date has been highly limited (eg Foresters Life) and early RDR consultations sought its withdrawal. However, lack of progress with any successor (initially named 'primary advice') and general criticism of the RDR reforms has meant that basic advice has been given renewed shelf life despite lack of demand.

4) EUROPE

The RDR is running concurrently with major consultations taking place in Europe on PRIPs and reviews of MiFID and IMD. The latter are now known as MiFID-2 and IMD-2 respectively. The latest MiFID-2 directive text was published in October 2011 but that covering PRIPs and IMD-2 has been delayed until at least February 2012. In deference to PRIPs, the FSA has already adopted a new 'retail investment product' category This includes packaged products but also structured investment products, all investment trusts and unregulated collective investment schemes including those that are exchange traded. In addition, it covers any other investment that offers exposure to underlying assets that are not a direct holding in the financial asset and in a packaged form.

The FSA has stated publicly that these new directives pose no insurmountable problems to the RDR (a further alignment of definitions may be necessary eg independence) although they may be on a maximum harmonization basis leaving little for national variation. However, market and political pressure will exist seeking to delay RDR implementation especially as the FSA is itself to undergo a major transformation into a 'twin peaks' regulator with the formation of a new Financial Conduct Authority (FCA).

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SUPERVISION OF RDR RULES

COMMISSION:
The FSA is set to identify and challenge any advisory firms who appear to be engaging in a drive for new investment business motivated by commission still being available up to late 2012. As part of their transitional supervisory strategy the FSA is examining the commission levels payable on investment bonds.

RDR PREPARATION:
The FSA will be undertaking further thematic supervision and will test how organisations are prepared for the RDR in advance of 2012 by gathering relevant data. The FSA has stressed it will be pro-active. In particular, the FSA will undertake two targeted pieces of work. Firstly, concerning centralised investment propositions (where a firm operates a standard approach to advising on investments using portfolio advice services. These normally involve model portfolios and refer clients to discretionary managers and distributor influenced funds). The FSA will monitor current practices in this area to ensure that customer service standards meet the RDR requirements. Secondly, the regulator will look specifically at the quality of advice when recommending clients to invest into single premium investment and pension products.

POST-2012:
In terms of post-2012 supervision, the FSA will ensure that firms have adapted their business models in light of the RDR requirements. The regulator will also check that product providers facilitating Adviser Charging payments are offering sufficient flexibility and not marketing themselves on the basis of the charge they might facilitate.

DATA:
Collection of data will be an important part of the FSA's supervisory approach.

The FSA published CP11/08 'Retail Mediation Activities Return and complaints data in May 2011. It set out proposals for collecting data through the current RMAR and complaints systems.

The proposed changes to Retail Mediation Activities Return (RMAR) incorporate the additional data needed from firms giving advice to support supervision of the Adviser Charging rules. There is no change to the timing, frequency and level of a firm's current reporting requirements. With regard to complaints, increasing the professional standards of advisers is a central element of the RDR and the FSA will focus in this area. Currently firms are required to provide the FSA with a complete report of complaints received twice a year. It is proposed that firms break down their complaints data to individual investment adviser level detailing:

- Number of complaints
- Number of complaints upheld
- Amount of redress paid in the firm's last reporting period.

It is also proposed that firms alert the FSA when an adviser is subject to three or more complaints in a 12-month period or an adviser is subject to a complaint with a claim of more than £5,000.

CONCLUSION - SO WHAT DOES IT MEAN FOR YOU?

Take Note - The RDR will undoubtedly transform the retail investment sector.

Product provider:

- A total ban on the payment of commission and other inducements.
- How will the business model be adapted to acquire new business in a non-commission world? Price, brand awareness, client service?
- What is the impact of the ban on allocation rates >100%?
- Do you wish to facilitate the payment of adviser charging by matched deductions (not factoring)? What are the IT systems implications?
- If vertically integrated how will charges be separated?

Adviser firm or sales force:

- Advisers must provide either an independent or restricted service. What will be the impact on the existing client base?
- All advisers must be qualified (minimum QCF level 4) and meet the new professional standards requirements.
- Must decide on a charging structure that's suitable for both clients and the business.
- IT systems and controls, advice processes and staff training programmes must be adapted for adviser charging plus new wider definitions for independent advice and retail investment products.
- Firms must revise their consumer disclosure statements and documentation to reflect their service offer accurately and fairly.
- Remuneration policies must be revisited in light of adviser charging.

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