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Dear Sir

RE: Developing our approach to implementing MiFID II conduct of business and organisational requirements

The Investment Association welcomes the opportunity to respond to the FCA's discussion paper.

The Investment Association represents the UK asset management industry. Our members manage over £5 trillion in the UK of assets on behalf of UK, European and international clients, both retail and institutional. Collectively, our members make up the second-largest asset management industry in the world.

We note that there are no questions associated with chapter 11, dealing with complex and non-complex products and the application of the appropriateness test. We have in the past made known our significant concerns about ESMA's advice to the Commission in this area and, in particular, the impact it will have on non-UCITS retail schemes (NURS) in the UK, which would all be considered complex and therefore subject to an appropriateness assessment. This could inhibit investment in NURS funds at a time when the strategies employed by such funds come to be increasingly in demand by investors seeking a drawdown income from their pension. We note the statement at paragraph 11.10, that "not all 'complex' products come with the same risks, and do not require the same level of knowledge and experience", and we look forward to discussing with the FCA how an appropriateness regime fit for NURS and other retail products might be framed. But by far the best result, in our view, would be that the Commission would ignore ESMA's advice in this area on the basis that, by inappropriately branding products as ‘complex’ when they are in fact no more complex than most ‘non-complex’ products, it is contrary to the best interests of consumers.

Below, we have provided our responses to the questions raised in your paper.

Yours

Adrian Hood
Regulatory and Financial Crime Expert

Discussion Paper – Developing our approach to implementing MiFID II conduct of business and organisational requirements

Q1: Do you agree that, in principle, we should look to ensure a consistent regulatory regime between insurance-based investment and pension products, and MiFID II investments? If not, please explain why.

The Investment Association has consistently called for and supported regulatory measures designed to help create a level playing field for substitutable products. In that context, we support the proposals as set out in section 2 of the DP.

Q2: Assuming IDD does not replicate MiFID II in terms of changes to suitability assessments and client reporting, we plan to apply minor changes where we currently read-across MiFID II rules to insurance-based investments and pensions. Do you agree with this approach? If not, please explain why not.

The Investment Association believes it is important for the FCA to continue its focus on facilitating the creation of a level playing field for substitutable products, so we agree with this approach.

Q3: Assuming IDD does not replicate MiFID II in terms of the appropriateness test, should we look to apply MiFID II's appropriateness test to sales of insurance-based investments and pensions?

The Investment Association believes it is important for the FCA to continue its focus on facilitating the creation of a level playing field for substitutable products, so we support the proposal to apply the appropriateness test to sales of complex insurance-based investments and pensions.

Q4: If we were to apply MiFID II's appropriateness test to insurance-based investments, what factors or criteria do you consider make an insurance-based investment and pension product complex?

With the aim of facilitating the creation of a level playing field for substitutable products, The Investment Association believes that MiFID II's appropriateness test should apply to insurance-based investment and pension products. If the Commission accepts ESMA's technical advice and all investments in non-UCITS collective investment undertakings are in future considered complex, it would seem to follow that insurance-based investment and pension products should be treated similarly, ie. they should all be considered complex, unless they are straightforward wrappers including only other non-complex investments, such as UCITS. Any other approach would have the potential to introduce competition distortions between substitutable products. A much more sensible approach could be achieved if the Commission ignored ESMA's advice in this area and adopted delegated acts defining an instrument as complex or non-complex based on objective criteria (which are already set out in Article 63(1) of the discussion document prepared by DG FISMA and dated 13/05/2015). In that case, individual non-UCITS collective investment undertakings, insurance-based investments and pension products could each be assessed on the basis of established criteria to determine whether they are complex or not.

Q5: Assuming IDD does not replicate MiFID II with regard to product governance and staff remuneration provisions, to what extent should we look to apply MiFID II's obligations to insurance-based investments and pensions? What would be the implications of doing this, or of not doing it?

The Investment Association supports the application of similar governance and conduct regulation for all providers of substitutable products, so we support the application of MiFID II product governance and staff remuneration provisions to insurance-based investments and pensions. Any other approach has the potential to create competitive distortions which might not be in the best interests of customers.

Q6: What should our approach be to incorporating the new requirements for structured deposits into our conduct of business rules?

The Investment Association has no strong views on the three options as long as the Commission's objective of a consistent investor protection regime for all MiFID investment products (including structured deposits) is met.

Q7: Should we develop rules to ban rebating of third party payments altogether by DIM firms to clients?

Yes, the RDR regime should be extended in a consistent way to DIMs. The FCA should also take the opportunity to consider whether legacy RDR third party payments to advisers should be subject to a sunset clause, as is the case with payments by third parties to platform service providers.

Q8: Should we develop rules to ban cash rebating of third party payments by DIM firms to clients, but allow other types of rebating?

No, the operation of different side by side regimes for advisers and DIMs would create unnecessary operational complexity.

Q9: Do you agree with our approach to re-categorise local authorities undertaking non-MiFID business as retail clients, with the option to opt up to elective professional client status? Do you agree that the opt-up criteria for local authorities should follow our existing approach with respect to non-MiFID business?

The Investment Association supports a consistent approach, regardless of product or business type, so we support the consistent categorisation of local authorities as retail clients for non-MiFID business, with the option to opt up.

Q10: Do you agree with the approach set out in option A and the possibility of providing guidance on the qualitative test? If so, please explain what sort of guidance you think would be useful. Please provide any evidence to support your views.

No, we prefer option C for the reasons given in our answer to question 12.

Q11: Do you agree with the approach set out in option B? Please provide your comments and any evidence to support your views.

No, we prefer option C for the reasons given in our answer to question 12.

Q12: Do you agree with the approach set out in option C? Please provide your comments and any evidence to support your views.

The Investment Association agrees with option C. It provides a higher level of investor protection, in line with the aims of the changes put forward by the co-legislators in MiFID II. It is also a more practical test for firms offering the service of portfolio management, rather than the dealing frequency test used in the MiFID elective professional regime.

There is one aspect of the re-categorisation of local authorities which was not addressed in the DP. The Investment Association is interested to know the FCA's views on how this part of MiFID II applies to local authority pension schemes, ie. does the FCA agree that, as pension funds, they are per se professional?

Q13: Do you consider that MiFID II's standard of independent advice is different, in practice, to the UK's RDR standard? If so, please explain why.

It is not clear what MiFID II's standard of independent advice consists of, but The Investment Association favours a period of post-RDR stability in the UK, so we encourage the FCA to maintain the standards in the current UK regime, subject to any marginal improvements that may come out of the FCA's own RDR review.

Q14: How should we implement MiFID II's requirement to develop an independence standard for advice on shares, bonds and derivatives?

The Investment Association has no strong views on this question.

Q15: Should we continue to include insurance-based investments and pensions within our definition of 'retail investment product'?

Yes, it would be a retrograde step to remove any products from the definition of 'retail investment product'.

Q16: Should we include structured deposits within our definition of 'retail investment product'?

Yes.

Q17: Do you think we should explore applying MiFID II's remuneration standards for sales staff and advisers across to non-MiFID business?

The Investment Association supports a consistent approach, regardless of product or business type, so we support the application of MiFID II remuneration standards to sales staff and advisers in other areas.

8. Recording of telephone conversations and electronic communications

Taping requirements for Article 3 firms

Q18. Do you agree that Article 3 firms should be subject to a regime that is identical to the regime for non-Article 3 firms? What impact would this have for these firms?

We agree with the FCA that ‘analogous to’ should not be read as ‘identical to’ or there would be no meaning to the differentiation allowed under Article 3. Any proposed rules should look to the underlying rationale of the MiFID II requirements, in terms of investor protection and preventing market abuse.

The FCA should ensure that it uses all its discretion in interpreting the MiFID II requirements, in the context of UK regulation to apply rules to UK investment firms and customers.

It is important, in any extension of the scope of MiFID II requirements beyond the minimum necessary, that the FCA conduct a thorough Cost Benefit Analysis, to ensure that true benefit accrues and firms, and customers, are not caused unnecessary expense.

Q19. What other approaches to recording do you suggest we could take that would meet the objectives of the MiFID II requirement?

Where it is possible the FCA should limit the extent of any recording requirement to those conversations which are not otherwise being recorded. Where electronic recording is either impractical or not strictly necessary, firms should be allowed to substitute alternative means of recording, such as minutes of face to face meetings, or letters confirming advice provided.

The current recording rules for discretionary investment managers

Q20. Do you agree that the two recording exemptions for discretionary investment managers should be removed?

While consistency, and a level playing field, are generally desirable objectives, this should not be at the cost of imposing unnecessary expenses on investors. Merely because a rule serves a purpose, and produces a positive Cost Benefit Analysis, in one situation does not mean that it should be applied in all situations, and certainly not where there is no benefit, and considerable cost, as this would, inevitably, be passed on to the underlying customer. As MiFID II determined that these recording requirements need not be imposed on discretionary investment managers (“DIMs”), they should only be imposed where the benefits are demonstrably greater than the costs.

The desirability and worth of requiring DIMs to record their telephone lines was considered at length in 2008. At that time all the benefits and costs were considered. It was decided (see PS08/1, particularly paragraphs 2.16 and 2.64) that, because the orders that DIMs were placing with brokers would, almost invariably, be recorded by the receiving broker, or other execution venue, that there was no discernible benefit to be gained by requiring the DIM to record them as well. There would have been considerable cost to such recording and record retention. This would represent an increase in costs and fees, which would cause a drag on clients’ performance.

This analysis has not changed since 2008. There is still no benefit to requiring DIMs to record their conversations with brokers, when the brokers are already required to record these same conversations. Any decision to change this position should only be taken following a thorough CBA.

Occupational pension scheme managers
A number of our member firms who, while DIMs, are dedicated to the discretionary management of one (or a number of closely associated) pension schemes for a large organisation (*OPS firms*). Because of the specificities of this arrangement there is little or no incentive to insider deal for the fund:

- OPS firm employees would not benefit from boosting the investment performance of the funds they manage, as even though they may be beneficiaries of the fund, as pensioners, the performance of the fund would not affect the pay-out of defined benefit pensions, merely the amount of funding that the scheme sponsor need pay to fund the scheme.

Nor are OPS firms caught in the scope of either MiFID or MiFID II. As such they should be exempted from any proposed telephone recording requirements, regardless of the outcome for DIMs generally.

Q21. Do you agree that discretionary investment managers should be required to comply with Article 16(7) of MiFID II?

We note that Article 16(7) of MiFID II applies to ‘transactions concluded when dealing on own account and the provision of client order services that relate to the reception, transmission and execution of client orders’.

Discretionary investment managers (“DIMs”) do not deal on their own account. Nor do they provide the service of ‘reception and transmission of orders’.

Recital 57 of MiFID II makes it clear that the telephone recording requirements apply only to conversations involving client orders, in order (*inter alia*) to ensure that there is evidence to prove the terms of any orders given by clients. The recital refers repeatedly to 'orders given by clients'. As such we consider that, as DIMs do not receive orders from clients, the third limb of the scope of this requirement does not apply to DIMs either.

As such, we agree with the assumption implicit in the FCA's discussion paper that the MiFID II telephone recording rules do not apply to DIMs. This is why the FCA asks whether, rather than how, it should apply the rules to DIMs. We do not consider that the telephone recording requirements should be applied to DIMs.

Because all relevant conversations with brokers will be recorded by the broker, there is no benefit in DIMs duplicating such recordings. While such duplication may, minimally, simplify the job of the FCA, should it ever need to request such a recording, this would be at the disproportionate expense of the investor. This expensive duplication of recording would be of no, final, benefit in detecting or deterring market abuse, nor would it change the result of any disputes between clients and firms.

DIMs are already (COBS 11.5) required to keep records of when and with whom they have placed deals. As a result it should be straightforward to trace recordings of all conversations, and we do not believe that the benefits of the proposed rules would be reduced by the small amount of extra work to which the FCA would be put, nor should the costs to the industry be increased any more than marginally.

From the NCA SARs Annual Report 2014 it has become clear that very few Suspicious Transaction Reports are reported by asset managers as a result of internal transactions. We conclude that this is not because they have failed to identify those that have occurred, but because investment managers are not natural routes for insider dealers: they are indirect, and would leave too well documented an audit trail, even without these new proposals.

The FCA has been content with the scope of telephone recording, which it set itself in 2008. Nothing has changed other than the introduction of MiFID II. MiFID II does not require the FCA to change its policy in this area, so we see no reason why the FCA should do so and, in doing so, impose extra unnecessary costs on DIMs and their investors.

Given the FCA's risk based approach, and in light of the fact that all calls between DIMs and brokers will be recorded by the sell side, we still consider that a carve-out for DIMs is proportionate.

Chapter 9 – Costs and charges disclosures
Technical challenges of implementing the costs and charges requirement

Q22: Are there any technical challenges firms are likely to face in meeting these disclosure requirements that you feel we might be able to help address? If so, what solutions do you suggest to overcome these challenges?

MiFID II will require aggregated disclosure of all charges and transaction costs. At the technical level of actually producing this information we believe the challenge is around the disclosure of implicit transaction costs, in particular quantifying the impact of bid/offer spreads at a portfolio level. Our position paper '*Meaningful disclosure of costs and charges',* published earlier this year, our response to the joint ESA's discussion paper on the PRIIP KID and our recent response to the FCA/DWP call for evidence on transaction cost disclosure to UK workplace pension schemes, set out at some length our views on this issue.

Beyond this we would note the main technical issue that the FCA can help to address is one of timing dislocation between MiFID II, PRIIPs and the UK pensions transparency work. All three regulatory initiatives will require the disclosure of transaction costs and product charges although the presentation of this information to end investors will be different, given the European focus on aggregation. However, until there is precise clarity on what transaction costs should be disclosed in a standardised framework, and on the extent to which these costs should be actual, estimated or assumed figures, there is a risk of each initiative imposing different requirements.

This is compounded by the fact that the UK pensions debate is out of sync with the timetable for MiFID implementation (3 January 2017), which itself has coordination issues: the delegated acts for MiFID are running ahead of the work on the PRIIP KID, where it is most likely that the scope of transaction costs will be robustly defined. What we wish to avoid is a situation where managers must comply with different disclosure regimes governing different client groups – at its most extreme this could create a situation where different clients investing in the same pooled fund could be subject to different disclosure requirements depending upon whether the latter are dictated by MiFID, PRIIPs or UK pensions legislation. It would also make it very difficult where funds or PRIIPs are themselves the underlying investments of pension schemes and their costs are expected to be reported as part of pension schemes' own disclosures. Such an outcome would be confusing for investors and other decision-makers, and costly and time-consuming for managers to implement since it would require systems to be adapted to serve multiple regimes whose intentions are ultimately the same (improved transparency for end investors).

The FCA can help mitigate this risk by ensuring alignment of all three regulatory initiatives so that a common disclosure framework can be applied to all clients regardless of whether the legislation governing their specific disclosure needs is emanating from the UK or Europe. Our response to the call for evidence outlines how such a framework could operate.

Standardisation

Q23: Should we investigate developing a standardised format for disclosing costs and charges for both point-of-sale and post-sale disclosures?

We agree that there may be some merit in investigating standardisation of MiFID II cost and charge disclosures if this does aid meaningful comparison between different products. In this regard we agree with the FCA's view that appropriate consumer testing and use of behavioural economics will be necessary in informing the presentation of disclosure documents to end investors.

In thinking about how to present such information we would argue strongly that aggregated costs and charges figures under MiFID II should show separately the components of the aggregated number. Combining costs and charges into one number without this split means that the number (when shown ex-post) represents at best the economic experience of monies invested – and not the charge for the service of investing client monies provided by the manager. Without this granularity, it is highly questionable whether consumer comparison across products and managers will be facilitated effectively.

When considering an aggregated number without showing the split between charge and cost components on a pre-sale basis, there is also a strong possibility of misleading the consumer because of the inherent unpredictability of future transaction costs – the pre-sale number would almost certainly differ significantly from the realised number.

At a broader level, we find it surprising that regulators appear to be about to remove existing metrics, seen primarily in the UCITS Ongoing Charges Figure, that allow consumers to see very clearly what fund managers are charging for a given service. Therefore, any standardisation should take account of the need to differentiate between (i) charges and transaction costs; and (ii) actual and estimated figures. Without considering these issues disclosure risks mis-informing consumers, not aiding them.

Q24: Do you agree that we should maintain domestic consistency and look to apply MiFID II's inducement standards for independent advice also to restricted advice?

The Investment Association has consistently supported the aims of the RDR. In that context, we support retention of the existing consistency of treatment in this area between independent and restricted advice.

Q25: Do you agree that we should continue to have a consistent inducements regime for sales of MiFID II products and insurance-based investments and pensions? If not, please explain why.

Yes, a consistent approach is essential to creating and maintaining a level playing field for substitutable products.