Retail Distribution Review:
New paradigm for investment services regulation?

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Abstract: *The article analyses the consequences of the Retail Distribution Review (RDR) in the UK market and its potential for implementation in other EU Member states. The RDR was launched in 2007 with the underlying aim to improve retail distribution through market-led solutions supported by regulation where necessary. The RDR targeted at three main problem areas: Labelling of advisory service (independent/restricted), Remuneration (including ban on commissions) and Professionalism (minimum qualification and maintaining of knowledge). The article describes the initial situation in the UK investment market, main problems identified by the Financial Services Authority, main building blocks of both the RDR and Thoresen Review of Generic Financial Advice, implementation of the RDR and its European legal dimension. The article further analyses the impacts of the RDR implementation using qualitative analysis. Particular attention is paid to the advice gap as one of the consequences. The article also discusses the possibility of RDR implementation in the Czech financial market. This article reflects state of affaires as per the end of March 2014.*

Keywords: Retail Distribution Review (RDR), Investment Advice, Investment Intermediary, PRIPS, MIFID, IMD

JEL codes: D14, D18, G22, G23, G28

I. Introduction

In recent years, there has been a huge increase in the use of capital markets for both general savings and special purpose savings like the retirement savings by general public. This evolution has made investment services provision an important political and regulatory issue. From this point of view, one of the most crucial investment services provided to retail consumers is financial advice[2] as it makes it possible to

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[1] This article was written in author's personal capacity and expertise. The opinions expressed in this article are the author's own and do not reflect the view of the Czech National Bank.
[2] Called "investment advice" in Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive

delegate, at least partially, the difficult and complex financial decision-making to financial experts who can counter decision-making defects (Moloney 2010: 192).

A report by the CFA Institute[3] suggests that *a number of markets, including Australia, Canada, India, the Netherlands, Switzerland, the United Kingdom, and the United States, have launched initiatives to improve access to financial advice, by both bringing greater transparency to the financial advice industry as well as addressing the problem of mis-selling*, including various disclosure duties and limits or bans on inducements.[4] One of these initiatives is the UK's Retail Distribution Review ("RDR") which has resulted in substantial changes to marketing and distribution of retail investment products models.

The EU retail market is strongly characterized by product intermediation in the form of or directly tied to investment advice and related investment product distribution services (Moloney 2010: 192). The UK financial advice regime illustrates the ability of some EU Member states to preserve their own rules corresponding to local risks, even in such a highly EU-harmonized area as the investment services provision is. One of the reasons arises from the fact that the UK financial advice market is, compared to many other EU member states' markets, to a certain extent specific. In the UK, financial advice is mostly provided by smaller "independent" financial advisers (the IFAs); commonly known as "personal investment firms". Therefore, the IFAs have always constituted a very important link between consumers and financial products originators in the UK. This UK financial advice market tailored regime is undoubtedly legitimate, but there is a substantial arbitrage risk between the MiFID and non-MiFID investment advice providers and single passport usage difficulties. On the other hand, the UK financial advice regime ensures the same level playing field for advising on substitutable and competing financial products. According to Niam Moloney (2010: 28) *By contrast with the segmented EC approach, the FSA has developed a specific and targeted cross-sector regime for the distribution of, and advice with respect to, "packaged products" or complex and long-term investment products which are sold to the mass market, typically by commission-based (usually*

2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (hereinafter "MiFID"). According to Article 4.4 MiFID *"Investment advice" means the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments*.

[3] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n15.1

[4] See also Annex 3 of FSA's Discussion paper DP07/1 'A Review of Retail Distribution' for international comparisons.

"Article 3") advisers. The question is whether the regulatory technique used was not too market-disruptive in comparison with EU harmonized financial advice regime and its' implementation by other EU Member states.

As the City of London Corp. Fellowship Programme participants, the authors of this paper decided to carry out a research on UK's financial advice business in the post-RDR era under the general heading 'Retail Distribution Review: New paradigm for investment services regulation?' The aim this paper (based on the abovementioned research) is to discuss the impacts of regulatory changes resulting from the RDR and their relationship with regulatory changes on EU level. The authors decided for qualitative research techniques which primarily involved unstructured interviews with a small number of respondents followed by a discussion. A fixed-wording questionnaire of the type used in quantitative research was used as a secondary source of information. The purpose and design of these research tools were to provide a deeper insight and understanding of the problem rather than a precise measurement.

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II. RDR: General aim

The RDR initiative dates back to 2006 when Callum McCarthy, that time the chairman of the Financial Services Authority, identified in his speech[6] several defects of the distribution system for financial products to retail consumers, notably product bias, provider bias and churning, following the previous announcement of the RDR by John Tiner.[7] Certain essential assumptions peculiar to the later adopted RDR can be identified: good guy assumption[8], ethical ground of proposed changes[9] and clear

[5] The questionnaire was designed as anonymous. Only those respondents, from almost fifty, who expressed their wish to be mentioned are acknowledged in this paper together with our interviewees.

[6] http://www.fsa.gov.uk/library/communication/speeches/2006/0916_cm.shtml

[7] http://www.fsa.gov.uk/library/communication/speeches/2006/0614_jt.shtml

[8] *I assume that the provider of the retail financial service wants over time to associate his or her brand with qualities of reliability, trustworthiness, performance, and to establish and develop a long term relationship with customers, so that they can benefit from those parts of the customer's life when he or she is accumulating wealth.*

recognition of responsibility in a distribution channel. One would easily agree that establishing an explicit responsibility in each part of the distribution channel is central to all legal-based regulation. However, getting always an ideal (almost Platonic) fair deal from any possible type of adviser is often later assessed as naïve and, to some extent, a dangerous standard when coming into wide variety of real-life advisory market situations, especially regarding the mass market. Many opponents would argue that regulation should not be used to "clean the way" for good guys but rather to prevent the bad ones from making any harm or to punish them for any misconduct. Similarly to McCarthy, when Steven Maijoor[10] from ESMA asked in February 2012 *What problems do financial consumers face when seeking advice?,* three main issues were highlighted: (i) lack of quality of financial advice, (ii) unsuitable products and (iii) inducements including the conflicts of interest, biases and prejudicial remuneration practices. The solution offered by both experts was more regulation and supervision as the *caveat investor* discourse in on decline.

As the RDR was meant to be a both consumer protection and the (good part of the) market protection initiative, authors of this paper decided to verify whether the aims and expectations of the RDR authors match the expectation of the UK financial market representatives. The respondents generally agreed on the reasons for the RDR introduction which were the perception of poor standards of unbiased and competent advice, perception that commission-based incentives were driving negative consumer outcomes and were undermining a sustainable retail investment distribution model in the UK, perceived product and trading bias and mis-selling of retail investment products as a result of commission-driven sales and low qualifications. On the other hand, according to the BME Report, only 8,1 % of consumers have had personal experience with mis-selling.

Although the above mentioned failings were undoubtedly partly present, the RDR was not based on any in-depth analysis of past events, current market features or financial advice market efficiency, but rather on the consensus in appointed interest

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[9] *There are some particular initiatives, which all derive from the treating customers fairly (TCF) programme…We need to see an advisory process which supports treating customers fairly.*

[10] Speech delivered on EP/EC (DG-Health and Consumers) event: 'Financial advice provided by non-profit entities to consumers' 7 February 2012 (ESMA/2012/73).

groups.[11] Therefore, it would be useful to briefly comment on pre-RDR financial advice regime.

Since 1988, there used to be two groups of financial advisers in the UK: independent advisers advising the consumer on a wide range of financial products and tied agents advising only on the products of one product provider (so called “polarization” regime). As a result of such a polarisation, advisers had to choose between an independent or non-independent (tied) status. **Both types of advisers were obliged to disclose their status to the consumer at the beginning of the advice process. The independence of the adviser was based on the range of financial products and was not related to remuneration structure.**

In 2004, so called “depolarization”, pretentiously termed as “significant liberalisation package”[12], which in fact brought only a split in the tied category and slightly more sophisticated disclosure obligation, could only increase confusion among financial advice users. The distinguishing features of “independence badge” became (i) looking across the whole market (as previously) and (ii) offering a fee option when providing financial advice. Unsurprisingly, the majority of consumers were not willing to pay for advisory services and chose the “free” advice option, even though they were, or at least they should had been, aware of conflict of interests arising from commission based remuneration as the information about this incentive formed a part of the initial disclosure.

So, one could rise the question where was the problem? The retail investment market is, not only in the UK, characterized by a strong pressure on the sale of investment products and by low level of consumer capability[13]. The main problem arising from this imbalance was mis-selling of particular (especially packaged investment products) financial contracts to consumers who were the least able to understand the nature of these products (however, this falls much more under suitability rules

[11] *We have been encouraged by the wide degree of consensus amongst market participants that the time is right for significant changes to be made. This has allowed the RDR to focus on exploring ways to deliver better outcomes for consumers without spending too much time analysing the past*. (FSA's Discussion paper DP07/1 'A Review of Retail Distribution': 4). However, the same could be said about EC regulation: *But the EC's post-FSAP rule base was developer without evidence on investor behaviour and without evidence on the structure of the retail market* (Moloney 2010: 116).

[12] http://www.telegraph.co.uk/finance/personalfinance/2749244/FSA-slams-sales-system-for-financial-products.html

[13] Financial Capability in the UK: Delivering Change, FSA, 2006, details in Atkinson, A., S. McKay, H.E. Kempson, and S. Collard, Financial Capability in the UK: Establishing a Baseline. Consumer Research 47, Prepared for the Financial Services Authority by Personal Finance Research Centre University of Bristol, Financial Services Authority March 2006.

enforcement), and were having a high degree of trust into the advice industry professionals. However, the RDR, mostly addressing the abovementioned systemic mis-selling, reflects rather political framing of the retail investment market problems, especially when the status disclosure (including commissions) is seen as being "not enough" from the regulatory point of view, rather than a rational consideration of the relationship between cost, benefits and proper regulatory techniques and tools. Moreover, the RDR was also closely concerned with the general promotion of market based savings (Moloney 2010: 47) as governments EU members states tend to step back from welfare provision and the amount of people who should be financially advised increases.

III. RDR: Main components

The RDR follows the main groups of systemic failures identified (see part II) and consists of three central parts: **(i) labelling of advisory service** (clear division independent/restricted advice), **(ii) remuneration** (including a ban on commissions) and **(iii) professionalism** (minimum qualification level and continual maintaining of the knowledge). All RDR rules can be assigned to one of these groups. This paper deals in particular with labelling and remuneration, whereas the professionalism component is suitable for a separate research.

It is also crucial to understand what exactly the RDR rules, included primarily in Financial Conduct Authority's COBS[14] 6 as the additional disclosure requirements, apply to. The RDR regime applies when a **personal recommendation to a retail client concerning retail investment product[15] is made**. There are numerous exceptions, the most important being that RDR rules do not apply if the retail client is outside the UK. Personal recommendation is defined as a recommendation in a form of an advice on investments or home finance transaction(s) which is presented as suitable for the person to whom it is made, or is based on a consideration of the circumstances of that person. A recommendation is not a personal recommendation if it is delivered exclusively through distribution channels or to the public. This

[14] Conduct of Business Sourcebook

[15] According to FCA Handbook Glossary retail investment product is (a) a life policy; or (b) a unit; or (c) a stakeholder pension scheme (including a group stakeholder pension scheme); or (d) a personal pension scheme (including a group personal pension scheme); or (e) an interest in an investment trust savings scheme; or (f) a security in an investment trust; or (g) any other designated investment which offers exposure to underlying financial assets, in a packaged form which modifies that exposure when compared with a direct holding in the financial asset; or (h) a structured capital-at-risk product; whether or not any of (a) to (h) are held within an ISA or a CTF.

definition corresponds with MiFID's definition of the investment advice. Consequently, the RDR rules do not cover all financial advice in the UK and they do not cover all investment products offered to retail clients. Crucial retail investment products which are not covered include stocks, bonds, pure protection insurance products, mortgages and structured deposits. The RDR rules also do not, by definition, cover non-advised (execution-only) financial services. There is therefore a risk that advisers who want to avoid the RDR's effects (especially the commission ban) will shift the scope of their activities towards non-RDR investment products or will claim that they are not providing "regulated" advice. CFA report suggests that increase in low-cost, information-only, execution-only business models is highly probable. The industry could also bypass financial advisers and pay commissions to those entrepreneurs able and willing to sell financial products without providing any advice. Finally, according to one of our respondent's opinion all financial products, including banking products, should have been subject to a similar review. Authors of this paper fully agree that retail consumers are in fact offered a wider range of investment instruments.

IV. Labelling of advisory service - Independent and restricted "badge"

According to long-dated regulation (from 1988 to 2012), advisers advising on "packaged" products were obliged to disclose their status, that is, whether they were independent from or (multi-) tied to the financial product originator. Obviously, this was not enough to get satisfactory consumers' outcome as the consumers have a fragmentary understanding of the way financial markets operate and tend to refuse the option of paying for advice on fundamental life-long decisions. According to the new RDR rules, financial advisers have to disclose to the consumer at the "initial disclosure" stage whether their advice is independent or restricted. The CFA Institute survey respondents obviously and understandably preferred disclosure-based rules but the statement "*Transparency should be part of any solution aimed at addressing mis-selling because simplified disclosures that give investors the information they need to make informed decisions can only improve the investment experience*" is not appropriate as the disclosure which had been in force for more than twenty years did not improve investors' decision making in terms of its' rationality. And the RDR didn't bring any substantial change.

According to the RDR rules, a firm must **not hold itself out to a retail client as acting independently unless** the only personal recommendations in relation to retail investment products it offers to that retail client are: (a) based on a **comprehensive and fair analysis of the relevant market**; and (b) **unbiased and unrestricted** (COBS 6.2A.3). Also, a firm must disclose in writing to a retail client, in good time before the provision of its services in respect of a personal recommendation or basic advice in relation a retail investment product, whether its advice will be: (1) **independent** advice; or (2) **restricted** advice (COBS 6.2A.5). Additionally, if a firm provides independent advice in respect of a relevant market that does not include all retail investment products, a firm must include in the disclosure an explanation of that market, including the types of retail investment products which constitute that market. If a firm provides restricted advice, its disclosure must explain the nature of the restriction. If a firm provides both independent advice and restricted advice, the disclosure must clearly explain the different nature of the independent advice and restricted advice services (COBS 6.2A.6).

Apparently, the new regulatory regime is going to give rise to more confusion among both consumers and advisers. The above-mentioned definitions are prone to be misinterpreted as they use language with blurred meaning, especially “relevant” market and “unbiased” recommendation. Especially in a situation where, according to Consumer Research Paper 78 from June 2009[16], *a label on its own is unlikely to be an effective way to inform consumers about the service they are getting as the same label means different things to different people* and additional explanatory information is necessary.

Moreover, in March 2014, the FCA published[17] the results of the second stage of its’ thematic review which focused on two key areas: whether firms that are describing themselves as independent are acting independently in practice and whether firms are complying with the disclosure requirements. FCA found that *a significant number of firms appear to understand the new requirements and there were no indications that these firms were acting in any way other than independently in practice*.

Authors of this paper came to a conclusion that, firstly, the concept of independent adviser and independent advice is not that simple and clear as may be expected, if

[16] FSA’s Consumer Research Paper No. 78 Describing advice services and adviser charging (2009)
[17] TR14/5 - Supervising retail investment advice: Delivering independent advice (http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-05)

there is a demand for a whole bunch of FCA's soft law guidance to establish a proper understanding of independence and non-independence.[18]

Secondly, the concept of "relevant" market seems to be the greatest challenge to the RDR rules' legal certainty as a relevant market should comprise all retail investment products which are capable of meeting the investment needs and objectives of a retail client (COBS 6.2A.11). How investment needs and objectives of a retail client could be rationally determined in situation when the retail investment products are "sold not bought", i.e. the market is supply driven and consumers are told what their needs are? For example, according to COBS 6.2A.13: *For a firm not specialising in a particular market, the relevant market will generally include all retail investment products*. This could be than interpreted as guidance for advisers to specialise in a particular market segment(s) to avoid fulfilling the duty to analyse all retail investment products. Also COBS 6.2A.17 puts the concept of relevant market into doubt: *In providing unrestricted advice a firm should consider relevant financial products other than retail investment products which are capable of meeting the investment needs and objectives of a retail client, examples of which could include national savings and investments products and cash deposit ISAs*. This wording leads to another set of questions: How the independent adviser should act regarding consumers' needs and objectives? How exactly should the financial adviser carry out a comprehensive and fair analysis, especially when the independent advice does not necessarily means analysis of all available retail investment products? Such an advice is evidently restricted but is considered to be independent and labelled accordingly. **One could conclude that the need of further explanation shows the problematic design of the initial RDR rules**.

V. Adviser charging

One of the perceived market "failures" was frequently mentioned by our respondents and during interviews and widely accepted in RDR's related documents: the commission bias. The RDR's response to the commission bias was a **complete ban on commissions** with few exceptions. According to COBS 6.1A.4 financial advisers

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[18] Some advisers express concerns and confusion regarding unregulated collective investment schemes, other non-mainstream pooled investments, structured products, venture capital trusts, enterprise investment schemes and exchange-traded funds (http://www.professionaladviser.com/ifaonline/feature/2335966/a-definitive-guide-to-what-independence-actually-means).

must **only be remunerated** for the personal recommendation (and any other related services provided by the firm) **through adviser charges**; and must not solicit or accept (and ensure that none of its associates solicits or accepts) any other commissions, remuneration or benefit of any kind in relation to the personal recommendation or any other related service, regardless of whether it intends to refund the payments or pass the benefits on to the retail client. Also, financial adviser must **disclose its charging structure** to a retail client in writing, in good time before making the personal recommendation (or providing related services) (COBS 6.1A.17), and must **agree with and disclose to a retail client the total adviser charge** payable to it or any of its associates by a retail client (COBS 6.1A.24).

Adviser charging may seem straightforward but FCA found[19] that 73% (of 113 firms surveyed) failed to disclose the true cost of their advisory service. It is obvious that many advisory firms try to bypass the RDR adviser charging rules and the essential question is whether it was necessary to completely ban commission in those cases where the advice is provided by a salesperson as it is seen as a substantial obstacle to a tiered advice system which is necessary for wide access to financial advice and which may better reflect investor needs (Moloney 2010: 278 - 279). Moreover, findings of the survey undertaken by authors of this paper show that there was a **general consent among respondents about a strong demand for simplified and cost-effective advice models.** It showed also apparent that most people have difficulties in interpreting adviser charges expressed in non-cash terms. Also, according to CFA Report *Retail investors tend to prefer a commission model to a fee-for-service model, which complicates the move toward fee models in markets that have banned commissions and may result in a large underserved population*. Obviously, the need for investment advice is not all-or-nothing issue as the general ban on commission could suggest. **UK retail investors prefer simple and straightforward advice services and commissions are not their main concern.**[20]

VI. Survey findings

As already mentioned in section I, information on already known or expected RDR impacts were also gathered from selected UK financial market practitioners (covering all main stakeholders – product providers' representatives, financial

[19] http://www.fca.org.uk/news/thematic-reviews/tr14-6-supervising-retail-investment-firms

[20] FSA's Consumer Research No. 70 *Consumer perceptions of Basic Advice* (2008) and FSA's Consumer Research No. 73 *Accessing investment products - Consumer perceptions of a simplified advice process* (2008).

intermediaries/advisors and consumers) using a fixed-wording questionnaire. The outcomes of this survey help to interpret other findings from different resources and published market data and can be grouped by topics as followed. All information in section VI was derived from the survey, unless otherwise stated.

a) Independent and restricted label

71 % of the respondents believe that only some of retail consumers understand the difference between independent advisers and other types of advisers. Actually, very small proportion of consumers understands the current distinction as most of them are familiar with pre-RDR definitions. “Restricted badge” is still misunderstood as it covers one company tied agent to "almost independent” adviser but independent advice as a long established concept in the UK is quite correctly understood by consumers (mainly because it was explained by their IFAs) even when it means something different in the post-RDR setting. There is also an opinion that consumers are not interested in the label itself but in the cost of advice which correspond to the widespread belief that consumers are generally unwilling to pay fees for the advice.

The abovementioned respondents also believe that only some of retail consumers understand the difference between independent and restricted advice. One of the respondents is of the view that none of them is able to understand the mentioned difference and other respondent wrote that only very few will understand the precise definition. Correct understanding of the independence label is more probable than of the restricted one. Generally, **consumers have difficulty in differentiating between information (which is unregulated generic advice) and regulated investment advice**.

Only 29 % of the respondents say that the concept of “unbiased and unrestricted advice” is understandable to all consumers. Slightly more than a half of the practitioners surveyed believe that the concept is understandable to at least some consumers. One of the respondents clearly stated that the majority of consumers seek suitable and affordable advice and that RDR has made advice unaffordable *for the masses*. **The unbiased and unrestricted advice is understandable to most of the advisers according to 71 % of respondents**.

The RDR did not help to remove consumers' cognitive biases regarding their perception of an advice/adviser according to 57 % and only partially according to almost a third of the respondents as this is understood to be a long-term task. Generally, retail consumers are seen as paying only little or even no attention to the RDR and the majority may be entirely unaware of it. However, an initial FCA research indicates that consumers welcome the extra transparency on the nature of investment services and costs and this is helping to build greater consumer understanding and rebuild trust.

b) Relevant market

86 % of the respondents think that the concept of "relevant market" understandable only to some of the consumers. Moreover, this understanding shall be only approximate and does not correspond to FSA definitions. According to one of the opinions, the concept of relevant market is of secondary importance to consumers who would prioritise whether an adviser is independent or not.

Two thirds of the respondents believe that the concept of relevant market is understandable to most of the advisers. **On the other hand, a precise relevant market determination could be a challenge for most of the advisers**.

c) Adviser charging

Regarding the proper way to remunerate advisers, **half of the respondents think that up-front fees is the better way of remuneration in terms of creating a link to the quality of an advice given**. However, **third of the practitioners surveyed picked another answer of the closed question being the RDR adviser charging rules** as the best way (as it allows fees to be spread across the term of regular investments so is more flexible that pure upfront fees paid by consumers) **or the opinion that remuneration has nothing to do with quality of advice to vast majority of advisers**. **57 % believes that fees paid by consumers actually reflect the quality of services being provided to the consumer** (29 % partially, 14 % not at all). For 83 % of respondents the situation where adviser firms decide themselves on their charging structures was the best solution (as in any other market).

There seems to be a widespread opinion among financial market professionals that commission would be acceptable, and make advice affordable to the men in the street, if the regulator had imposed a fixed rate of commission and terms

of payment across the board so that advice could not be influenced by some providers paying higher commission than others. It is true that post-RDR consumers have clarity over what they are paying for but it does also mean that advice becomes more exclusive for the better off. Also, greater transparency on charging and the services for which these charges are paid empowers consumers by being better able to compare competing services and to hold providers to account.

d) Professionalism

43 % of respondents see a direct causality relationship between the level of qualification of an advisor and the quality of his/her advice and the same proportion thinks there is partial causality relationship. 14 % don't consider it to be true description of reality. Experience and soft skills also has a significant part to play in the quality of advice.

Regarding main advantages and disadvantages of professional standards/accredited bodies system, the main advantage is seen in the **setting the minimum level of competence, a certain level of consistency and a level playing field**. Also, membership of professional standards bodies may help to underpin minimum professional standards across a particular industry sector and encourage continuous professional development on the supply-side to the benefit of consumers. On the other hand, the main disadvantages comprised of of the post-RDR system being **too exam based, costly and that not enough credit is given by one body to exams of another**. There is also a concern regarding "gold plating" the regulatory requirements by professional bodies. The new exams are considered the **primary cause of many experienced advisers leaving the market**.

e) Direct impact

The vast majority (almost 90 %) of respondents share the opinion that a substantial amount of independent financial advisers, especially experienced near-retirement ones, left the industry after implementation of the RDR with many more to come over next few years. This can also be demonstrated by FCA data. Both relevant data series show a year-on-year drop in the numbers of advisers: persons with permission to give investment advice, including financial advisers, bankers and stockbrokers (drop from 40,000 to 32,000) and independent financial advisers (drop from 26,000 to 21,000).

Regarding the overall costs of doing advisory business (initially expected to have increased substantially), there was no consensus as half of the respondents agreed and the other half disagreed, with a minority having no opinion. The reason may most probably be the lack of hard data. There is a view that **the cost of compliance has risen significantly due to the increased level of monitoring and intervention needed**. Also the costs imposed by the professional bodies make it more costly to be/employ an adviser.

According to 86 % of respondents, the volume of independent advice provided has decreased as well as have the volume of restricted advice provided (57 % declared a decrease whereas 29 % believe it has increased). One of the respondents expressed the opinion that the level of independent advice will most likely have decreased as many firms that were independent before the RDR were later the day forced to became restricted because being specialized in so called niche markets (such as pensions or portfolio management) rather than trying to be a "jack of all trades". The decrease in restricted advice provision is mainly due to a **substantial reduction in the UK retail banks offerings** which had led to a significant reduction in the number of bank advisers by some 35 %. Slow shift to restricted model could be considered as a general trend.

The competition in advisory industry increased according to only 40 % of the respondents. As aptly expressed in one of the opinions, the answer depends on the consumers segment. A significant reduction in restricted advice delivered by **retail banks has not only reduced the access of investors to advice and but also decreased the level of competition in the mass market advisory service. But in the wealthier consumer segment, the level of competition has increased** as providers focus their advisory offerings on this market segment.

The average fee charged by advisors per contract shall have increased according to 50 % of the respondents but has to be noted that it is obviously still too early to make categorical conclusions.

60 % of the respondents share the opinion that the overall quality of financial advice has increased, the remaining 40 % went for the "no change" answer. Loss of ill-informed advisers has probably increased the average quality. On the other hand, the overall quality of advice will have decreased due to the exodus of a significant number of more experienced advisers. Improvement of the quality of

advice is expected given the removal of remuneration biases, greater professional standards and increased consumer scrutiny.

f) Main concerns regarding effects of the RDR

Broad variety of answers can be found in this open-questions category, ranging from the concern that some firms are sidestepping the RDR to "it's too early to say". However, the most common opinion was that **financial advice is now unaffordable to the people who need it most and they are forced to use execution only services which create a major problem for the next generation. The reduction of access to investment advice for the mass market creates the risk of "mis-buying" investment products or staying underinvested.** To cite one of our respondents… *we are now starting to realise what no advice being available actually means.*

Within the survey, certain concerns were mentioned regarding the RDR's relation to other European regulatory initiatives in terms of over-complication and mixture of requirements but generally, MiFID II[21] and RDR "super-equivalence" will persist.

VII. Interaction of the RDR with relevant European rules

Generally, substantial parts of the RDR exceeds the MiFID requirements and are already subject to a notification to the European Commission according to Article 4 of MifID Implementing directive where this directive made such a "gold plating" possible.

PRIPS[22], IMD 2[23] and MiFID II initiatives are all aimed at rebuilding consumer confidence in financial markets. PRIPs Regulation includes basic definitions of "packaged retail investment product"[24], "insurance-based investment product"[25] and

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[21] Later adopted as Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast)

[22] We are going to use traditional abbreviation in this article but in fact the new one (PRIIPs) should be used according to text adopted by European Parliament on 15th April: *Retail investors are increasingly offered a wide variety of different types of packaged retail and insurance-based investment products (PRIIPs) when they consider making an investment.* (Position of the European Parliament adopted at first reading on 15 April 2014 with a view to the adoption of Regulation (EU) No .../2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance based investment products (PRIIPs) P7_TC1-COD(2012)0169) (hereinafter "PRIPs Regulation").

[23] Draft European Parliament Legislative Resolution - Insurance Mediation Directive proposal version PE502.060v03-00

[24] *an investment, including instruments issued by SPVs as referred to in Article 14 (26) of the Directive 2009/138/EC Article 4(an) of the Directive 2011/61/EU , where, regardless of the legal form of the investment, the amount repayable to the investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the investor*

[25] *an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations*

"person selling a PRIIP"[26]. However, PRIPs Regulation does not apply to particular pension products. For some reason the originally proposed definition of a person selling investment products as *a person advising, marketing, distributing or selling investment products to a retail investor, a distributor or a person acting as an intermediary for an investment by a retail investor* was abandoned but the scope of PRIPs Regulation was reformulated to include advice.[27] **PRIPs Regulation could lead to minor adjustments in the RDR's retail investment product definition**. **Wider definition of retail investment products can, according to our view, nothing but to improve the current regime as not only RDR-covered financial products are offered to retail consumers.**

According to MiFID II (Article 4.1.(4)) investment advice means the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments. MiFID II Article 24 (4) provides that when investment advice is provided, the investment firm must, in good time before it provides investment advice, inform the client: **(i) whether or not the advice is provided on an independent basis, (ii) whether the advice is based on a broad or on a more restricted analysis**[28] and (iii) whether the investment firm will provide the client with a periodic assessment of the suitability of the financial instruments recommended to that client. Generally, i.e. when providing any investment service investment firm must **provide the information on all costs and associated charges** which must include information relating to both investment and ancillary services, including the cost of advice, where relevant, the cost of the financial instrument recommended or marketed to the client and how the client may pay for it, also encompassing any third-party payments.

In case where an investment firm informs the client that investment advice is provided on an **independent basis**, that investment firm **shall assess**[29] **a sufficient range of financial instruments available on the market** which must be sufficiently diverse with regard to their type and issuers or product providers to ensure that the

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[26] *a person offering or concluding the PRIIP contracts with a retail investor*

[27] *This Regulation shall apply to the manufacturers and persons advising on or selling PRIIPs.*

[28] *…of different types of financial instruments and, in particular, whether the range is limited to financial instruments issued or provided by entities having close links with the investment firm or any other legal or economic relationships, such as contractual relationships, so close as to pose a risk of impairing the independent basis of the advice provided*

[29] The criteria for the assessment of a range of financial instruments available on the market will be provided by EC delegated legislation (Art. 24 (13) MiFID II).

client's investment objectives can be suitably met and must not be limited to financial instruments issued or provided by the investment firm itself or by entities having close links with the investment firm; or other entities with which the investment firm has such close legal or economic relationships, such as contractual relationships, as to pose a risk of impairing the independent basis of the advice provided. In this case the investment firm also **shall not accept and retain fees, commissions or any monetary or non-monetary benefits** paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients.

Generally, Member States may, in exceptional cases, impose additional requirements on investment firms in respect of the matters mentioned above. Such requirements must be objectively justified and proportionate so as to address specific risks to investor protection or to market integrity which are of particular importance in the circumstances of the market structure of that Member State (Article 24 (12) of MiFID II). Standard EC notification process applies in these cases.

The new MiFID II regulatory regime seems to be confusing as it distinguishes the fee based “advice provided on independent basis” and the “advice based on a broad or on a more restricted analysis” which is also, however, considered to be independent. **We believe that the intent of the author of MiFID II was basically to separate independent fee based advice and all types of tied (non-independent) advice, but the actual wording is not adequate to achieve this goal without confusion. Nevertheless, it is certain that commission ban applies only when the intention to provide the independent advice is communicated towards the consumer**. However, independent advice could be based on a continuum ranging from restricted to broad market analysis and we are sure that more ESMA guidance is going to be needed in this case.

IMD 2 is based on regulation of certain activity - insurance mediation - which means the activities of advising on, proposing, or carrying out other work preparatory to the conclusion of insurance, concluding such contracts or assisting in the administration and performance of such contracts. The activities of advising on, proposing or concluding contracts of insurance shall be considered to be insurance mediation also if carried on by an employee of an insurance undertaking in direct contact with the insured, without the intervention of an insurance intermediary (Article 2. 1 (3) of IMD

2). Comparison websites are also considered to be insurance mediation.[30] **IMD 2 also includes insurance-based investment product definition[31] and in Article 22 and cons. introduces MiFID II regime as an additional consumer protection requirements in relation to insurance investment products.**

The MiFID II, and consequently the IMD 2, allows both remuneration structures fee-based and commission-based, except for the provision of advice "on an independent basis". However, imposing further restrictions on remuneration above the minimum standards by EU Member states is allowed. Therefore, the RDR's general ban on commissions will be easily retained in the UK. **But, adjustments to the RDR's independence and related issues could be necessary.**

VIII. Access to advice

In the pre-RDR times, advisers were remunerated by product originators through an up-front and annual commission set as a percentage of the amount invested. This allowed to serve all client segments even if the amount invested didn't cover all costs because the whole portfolio of clients (with low, middle and high amounts invested) generated the desired income making the advisory business model effective. There might had been an issue whether clients were willing to pay what the advisers asked for[32] but generally, the remuneration system worked (with all the problems leading to the bank on commissions) in terms of allowing advice to all investors. This was crucial not only in the phase of selecting particular investment products or setting parameters of the investment but also in the very first phase where a financial plan was created. Financial planning in terms of budgeting, specifying the amount to be invested and taking into account all other financial assets, liabilities and risks is a

[30] Provision of information concerning one or more insurance contracts in accordance with criteria selected by customers through a website or other media and the compilation of an insurance product ranking list, including price and product comparison, or the discounting of premiums, when at the end of the process the customer is able directly to conclude an insurance contract using a website or other media shall be considered to be insurance mediation.

[31] an insurance product which offers a maturity or surrender value and where that maturity or surrender value is wholly or partially exposed, directly or indirectly, to market fluctuations, not including: (a) non-life insurance products as listed in Annex I of Directive 2009/138/EC (Classes of Non-life Insurance); (b) life insurance contracts where the benefits under the contract are payable only on death or in respect of incapacity due to injury, sickness or disability; (c) pension products which, under national law, are recognised as having the primary purpose of providing the investor with an income in retirement, and which entitles the investor to certain benefits; (d) occupational pension schemes that are officially recognised and that fall within the scope of Directive 2003/41/EC or Directive 2009/138/EC; (e) individual pension products for which a financial contribution from the employer is required by national law and where the employer or the employee has no choice as to the pension product or provider.

[32] The analysis done by Delloitte shows advise charge on an investments of 50.000 GPB is higher than the investor is expected to be willing to pay. For higher amounts invested, the advice fee charged by banks seems to meet the demand side whereas the IFAs still seem to be charging more than the investors are willing to pay. See Recognizing RDR reality: The need to challenge planning assumptions, Delloitte LLP, 2013.

crucial element of ones' financial decision. Such planning, especially in the context of savings and investments, also needs to capture the complexity of the market. This, **in the context of a general low level of financial capability, clearly explains the need for financial advisers' assistance**.

After the RDR implementation, an advice gap is generally expected to be one of the negative consequences. Experts consulted by the authors of this paper believe that around half of the advisers won't offer advice for investors with less than £50,000 invested. This doesn't mean that investors with some £10,000 couldn't be served but for those, an advice would cost between £500 and £1,000 – an amount making the advice too expensive. This consequence – a limited access to paid advice, especially for low-amount investors – was identified from the very beginning, with two solutions. One was the primary advice envisaged by the RDR which hasn't developed (yet) and could be seen as one of the disappointments of the RDR. A better one was described in the Thoresen Review of generic advice (2008) - the **National Money Guidance Service** (hereinafter the Money Guidance). Such service was **expected to deliver generic advice covering all abovementioned key elements of planning**[33]. Despite the fact that the Thoresen Review was presented as a parallel initiative (that should, in the end, be joined up with the RDR), it seems to be rather a key element of the whole advisory services change. From this point-of-view, we cannot agree with the Thoresen review statement that the Money Guidance is not a prerequisite for FSA-regulated advice. On the contrary, a well-functioning free-of charge system of generic advice provision should be a prerequisite for any regulatory change that creates an advice gap. From this finding we could derive that firstly, the success of the RDR in the UK financial market is closely linked with the success of implementing the Money Guidance, and secondly, any attempt to switch from free-of-charge advice to paid advice only model has to be accompanied with a solution for delivering generic advice to retail savers/investors.

In the UK market, **the Money Guidance should be delivered by the Money Advice Services** (hereinafter the MAS). Despite the fact it is way too early to assess the success of the MAS delivering generic advice, it is necessary to have a look at least on the scope of services offered by the MAS as well as its capacity. The Thoresen

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[33] See the Thoresen Review of generic advice: Final report, p. 8.

Review expected the Money Guidance to serve some 4 mil. retail clients per year[34]. MAS expects to face some 16 mil. contacts in 2014/2015, 6 mil. of times when help will be given and 4.5 mil. of actions to be taken as a result of the Service.[35] As the first number mentioned covers all contacts, incl. repeated visits to the websites, the number of actions to be taken resulting from engaging with MAS should be the most appropriate number. It also matches the goal set out by the Thoresen Review. This number could be compared with the capacity of the financial advisers. In pre-RDR times, there use to be 40,000 advisers active in the market (see previous chapters). If every of them served some 100 low-amount savers/investors, they would, in total, cover 4 mil. people annually. These clients used to be only a part of the whole client portfolio so such an amount of clients could be close to the reality. From this point-of-view, the capacity of MAS seems to be appropriate to the need of the market. On the other hand, the MAS services (even if well advertised) is a "demand service" meaning that the savers/investors have to be aware of the existence of the service and motivated to make use of it. This requires a certain level of financial capability which is according to several existing survey absent.

Regarding the scope of services, the MAS helps in both saving and investment, incl. long-term investments and saving for retirement (pensions). It needs to be mentioned that the MAS is not the only advisory service with such coverage. Which? could serve the same purposes but compared to the MAS, Which? offers its advice and guidance to members only (700,000 in 2014) and is not a free-of-charge service. Another service – the T-PAS – focuses on pensions only and the Citizens' Advice Burreau covers debt advice only. So MAS remains the only channel effectively covering the post-RDR advice gap.

IX. Conclusions

First of all, in contrast with the initial expectations and our questionnaire responses, no financial advisers' exodus has happened so far. According to the recent AFPA report[36] *adviser numbers fell in the run-up to the RDR as those who chose not to take the new qualification left the market. There has been a smaller recovery since because some passed their final exam a bit late or staff from the banks joined advice*

[34] See the Thoresen Review of Generic Advice p. 14 expecting the service to roll out gradually starting in 2009 and reaching a steady state in 2013.

[35] See MAS 2014/2015 Business Plan – Key performance indicators, p. 39.

[36] http://www.apfa.net/publications/financial-adviser-market/apfa-the-financial-adviser-market-in-numbers-v2.0.pdf

firms. Also, regarding the potential consumers exodus, NMG Consulting research suggests that *consumers continue to believe in the benefits of using a financial adviser post-RDR, with many investors more likely to consider advice than they were previously.*[37] **Although these "many" investors represent only around 35 % (the likelihood of using advice as a result of the RDR, suggested by Personal Finance Society Survey[38]) of the non-advised public which represents 66 % of the UK's population, the overall outcome is positive.**

The RDR reform was particularly based on the statement that commissions paid by investment product originators to financial advisers pose substantial risk to the quality and objectivity of investment advice. It is undoubtedly true, but there is obviously an **inherent regulatory assumption that a high quality and impartial advice is a default option in the investment advisory market and that is what exactly all consumers would like to have but are reluctant to pay for**. Therefore, FSA decided to ban all advice channels except those paid by consumers without carefully considering the commercial viability of other possibilities and offering alternative and complementary forms of advice. **FSA sacrificed a wider access to advice to the quality of advice, although it simultaneously identified the need for a simplified advice at the time but without offering any particular solution. The Money Advice Service or Which? do play an important role but both with a limited coverage.**

There is generally shared term "market failure" used in the regulatory rhetoric among public authorities and the majority of regulation theorists. However, there is at least one crucial problem with this concept. Market which has failed and which is going to be "repaired" by regulation has never existed. Regarding financial advice business, there always have obviously been only two basic categories of intermediaries: **financial advisers advising to their clients, remunerated by their clients and therefore being their status or fact-based fiduciaries, and salespersons acting on behalf and in the interest of product originators as their agents. Every regulation which does not respect this fundamental distinction is doomed to fail**. The cornerstone of the financial market regulation, the MiFID, does not respect it either and stipulates general fiduciary-style obligation in article 19 (*an investment firm*

[37] http://www.moneymarketing.co.uk/first-consumer-research-clients-remaining-loyal-to-advisers-post-rdr/1072809.article
[38] http://www.cii.co.uk/media/5139793/pfs_rdr_consumer_report_feb2014.pdf

act honestly, fairly and professionally in accordance with the best interests of its clients) merging financial advisers and sale-persons into one group with the same rules to by followed. **The MiFID II[39] shares this flawed conceptualization of financial advice and does not distinguish between consumers' fiduciaries and product originators' agents with their own duties towards their principals and therefore creates a serious instance of conflict of interests.**

As already indicated, several risks resulting from UK's RDR project can be identified. Information gathered by our questionnaire-based survey and interviews corresponds to a large degree with findings in CFA report, especially that *larger financial institutions are moving away from providing advisory services to smaller clients because of a lack of economic incentive to serve those clients* and that *in markets that ban commissions, new platforms with direct-to-consumer or low-cost/low-service investment options are expected to proliferate*. Therefore, **two main risks can be expected - the advice gap and unsuitable investments sold to retail consumers through a wider use of less supervised channels and web-based services**. Moreover, another risk is the advisers' bias towards non-RDR financial products. Back doors are obviously not shut.

Another important concern is that the **definition of independence is too complicated**. It would be better to see it not as a question of the nature of an advice given but rather as a remuneration structure problem. **Only those advisers who are paid by consumers can be considered independent** (from the influence of product originators) **and the RDR adviser charging regime is justifiable**. However, the RDR adviser charging rules apply to all advisers and this **negates the basic logic of independent adviser/salesperson distinction and could lead to widely anticipated advice gap as it limits tied advisers from providing their services**. Whether independent and tied advisers provide quality advice according to their role in distribution channel is not a task for the regulator but for the market forces, although **we generally consider new professionalism rules as a good move forward**.

The European Commission proposals for the MiFID review seem to be a promising step in the right direction. However, according to MiFID II, an independent advice provider in the EU will not be obliged to be strictly "whole-of-market" and a tied

[39] Paradoxically, IMD 2 (Articles 17, 18 and 24) seems to offer better designed solution.

adviser will continue to be paid by commissions. Therefore, **substantial part of the RDR will still be under the "gold plating" notification regime** which is necessary because the EU Member states need to address their local financial advice problems but a certain minimum level of harmonized rules is also required for the functioning of the EU single market project.

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