

28 November 2006

Richard Stobo  
MiFID Implementation Office  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

Dear Richard

### **Response to CP06/19: Reforming Conduct of Business Regulation**

The Investment Management Association (IMA) is the trade body representing the UK asset management industry<sup>1</sup>.

I attach our response to the detailed questions posed in the consultation. I draw your attention to the following issues of particular concern to IMA members:

- Chapter 2 – deferral of non-MiFID COB and Article 4 issues
- Chapter 7 – treatment of fund managers as clients
- Chapter 15 – appropriateness test
- Chapter 16 – best execution
- Chapter 29 – outsourcing of retail portfolio management

We have discussed with sell-side associations the interaction between best execution and client status. We agree with sell-side associations that the question of whether or not best execution applies should not affect other client protections, including those relating to conflict of interest management and protection of client assets. We and the sell-side associations believe that it is proper that buy-side firms should be entitled to the right level of protection as clients, even where best execution does not apply because of ECP status, or as otherwise agreed. It is important for the Handbook and FSA's other interpretative material to support this position.

---

<sup>1</sup> IMA members include independent fund managers, together with the asset management arms of banks, life insurers and investment banks, and occupational pension scheme managers. They are responsible for the management of nearly £3 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pension and life funds), private client accounts and a wide range of pooled investment vehicles. In particular our members manage 99% of UK-authorized investment funds (i.e. authorised unit trusts and open-ended investment companies).

You will note that for both Consultation Papers (CP06/19 and CP06/20) we have considered and responded on all your questions. In the event that new issues come to our attention we shall raise them with you at the earliest possible moment – whether or not they are within the deadlines imposed within these Consultation Papers.

Should you wish to discuss any of the points we have raised in further detail please do not hesitate to contact us.

Yours sincerely

Angus D M Milne  
Senior Adviser

## **CP06/19 QUESTIONS & ANSWERS**

### *General Points*

FSA refers to 'third countries' as being outwith the EEA. MiFID specifically refers only to EU countries as Member States. Where do EEA countries fall? How are they caught within the FSA rules, when MiFID does not seem to include them?

"Collective investment undertaking" is used in several places in COBS (e.g. 16 Annex 1 1.9(1)(d), 17.2.1(5)), but not defined. Given the rules in which it is found it would be very useful if the FSA could include a definition for this term in the Glossary. We would suggest that a possible definition for would be:

Any regulated or unregulated collective investment scheme: which will include unit trusts, ICVCs, investment companies, and venture capital trusts.

## **CHAPTER 1: OVERVIEW**

**Q1: Do you have any general comments on the way in which we propose to transpose the relevant requirements of MiFID?**

We support the overall method of transposition, subject to the comments and observations that we make through the body of this response.

## **CHAPTER 2: OUR GENERAL APPROACH TO REFORMING COB REGULATION**

### **Q2: Are there any additions to the list of deferred matters in Annex 5 which we should consider in the second quarter of 2007?**

We have no suggested additions to the list of deferred matters set out in Annex 5.

### **Q3: Do you have any comments on our general approach to reforming COB regulation or our analysis of the implications for firms and consumers?**

The deferral of consideration of non-MiFID business for CIS operators is unfortunate. Many of our members will have businesses which cover the whole range – MiFID firms, non-MiFID firms, and mixed-business firms.

Indeed, the problem is, for a number of our members, wider still. Clients of the asset management firm may also be, for example, clients of an in-house insurance subsidiary (or parent), and it would be helpful to be able to undertake the necessary reviews across all parts of the business, and implement any required changes prior to the implementation deadline.

The lack of clarity over the rules that will therefore apply to a part of the business is unhelpful, will make it harder and more costly to ensure that the whole business is ready by 30 November.

### **Q4: Do you have any comments on our general approach to using Article 4 to retain parts of our existing conduct of business regime?**

We have previously commented to the FSA on the intention to continue with the IDD and Menu (see Appendix 1). We regret that the FSA decided to continue its existing policy, and look forward to an opportunity to comment on the justifications for the Article 4 notification.

Other comments:

We support the FSA in the comments made in para 2.15. We look forward to the FSA creating a level playing field in the retail product sector.

We note and welcome the FSA's intention to supplement NEWCOB with additional information to aid predictability. However, there is some concern about the ability to create enforceable standards without a rule being in place. Standard-setting by website and speech may create less rather than more predictability. Reducing the size of the Rulebook by greater reliance on Principles supplemented by many hundreds of pages of examples may not result in less regulation, nor in more risk-based regulation.

We welcome the comments made about the significant challenges created by the move to greater principles-based regulation and the implementation of MiFID. There are challenges here for firms, for FOS and for FSA, and the communication and training programme will be welcomed.

**CHAPTER 3: THE STRUCTURE AND CONTENTS OF NEWCOB**

**Q5: Do you have any comments on the proposed NEWCOB structure?**

We have no comments at this time on the structure of NEWCOB.

## **CHAPTER 5: APPLICATION**

**Q6: Do you agree with our proposals for Chapter 1 and Appendix 1 of NEWCOB?**

We have no comments at this time on the proposals for Chapter 1 and Appendix 1 of NEWCOB.

## **CHAPTER 6: CONDUCT OF BUSINESS OBLIGATIONS**

### **Q7: Do you agree with our proposed implementation of MiFID Articles 19(1) and (3)?**

We support the FSA's proposals

### **Q8: Do you agree with our proposals for section 2.1 of NEWCOB?**

We support the FSA's proposals

### **Q9: Do you agree with our proposed approach to implementing the MiFID inducement provisions?**

We agree with the proposed approach to the implementation of the inducement rules.

Other comments:

Our reading of COBS 2.3.6 is that a 'general recommendation' would include a recommendation made by a firm to a client to use the services of another firm, and therefore the payment of introductory fees to the introducer would be deemed to be an enhancement.

COBS 2.3.1 covers both the payment and receipt of fees and commissions, and it would therefore be useful if the guidance on inducements included confirmation that the principal responsibility for disclosure lies with the distributor, with the firm having the direct contact with the client.

COBS 2.3.15 allows, Item 13, for a product provider to meet the costs of any training facilities provided, and Item 7 allows for the a product provider participating in another firm or third party's seminar. Should item 13 be expanded to specifically allow a firm to meet all the costs of any training that it provides to a firm?

### **Q10: Do you think that there will be 'non-monetary' benefits that you currently provide/receive and which are permitted under COB that you consider will not be permitted under NEWCOB?**

We are not aware of any such non-monetary benefits.

**Q11: Do you agree with our proposed approach to implementing the MiFID inducement provisions in relation to retail non- MiFID business and firms?**

We support this approach.

**Q12: Do you agree that COB 2.3 should be retained to allow MiFID firms to rely on information provided by non-MiFID firms?**

We support the retention of COB 2.3

**Q13: Do you agree that a provision equivalent to COB 4.1.5 should be retained to allow firms to treat a person acting as agent as their client in certain circumstances?**

We support the retention of a provision equivalent to COB 4.1.5

**Q14: Do firms agree with our approach to dealing with the scenarios currently covered by COB 5.8? Do any additional risks or concerns for firms or investors arise under this proposal?**

As representatives of the investment management industry we do not have any comment to make on this point.

**Q15: Do you think removing the 'exclusion of liability' rules would have a detrimental impact on consumer protection?**

We believe that the removal of these rules will not have any detrimental effect on consumers.

## CHAPTER 7: CLIENT CATEGORISATION

The position of portfolio managers is fairly unique in relation to client classification, due to the fact that in managing portfolios they are both acting on behalf of their clients and are themselves clients when they carry out the decisions they have made on behalf of their own underlying clients. Portfolio Managers therefore need to consider the effect of the FSA's proposals to implement the MiFID client classification regime both as a firm and as a client. Our comments below, deal with each of these scenarios in turn. However, although we deal with each position separately for ease of analysis, in practical terms, these two aspects of a portfolio manager's business do not operate in isolation, as the client classification provided to a portfolio manager will inevitably have an impact on the ability of the portfolio manager to act in the best interests of its own underlying clients.

### Position of portfolio managers as clients

#### *FSA's general approach*

- We are very disappointed in the FSA's overall approach to the position of Portfolio Managers as clients, in particular the FSA's approach to the position of portfolio managers currently treated as intermediate customers. Under the new regime such firms are likely to be treated as ECPs (unless they can agree with broker/dealers to treat them as professional clients), even where they have a pre-existing relationship with a broker/dealer which classifies them as an intermediate.
- As a result, it is highly likely that portfolio managers will have to negotiate new terms with each of their existing brokers/counterparties. This will be incredibly time consuming and could result in portfolio managers potentially being treated differently from a regulatory standpoint by different brokers for the same business.
- Smaller firms are likely to be most affected and least able to negotiate suitable terms going forward. It is also likely that, given the amount of work negotiating new terms will involve, many portfolio managers will end up just accepting the position imposed upon them by brokers and counterparties.
- Alternatively, and in light of the November 2007 deadline, managers may have to work on the basis of agreeing terms with a far smaller number of counterparties than they presently have, reflecting the limited resource that will be available to negotiate and conclude complex contractual agreements.
- In principle we consider this to be an anti-competitive effect of the FSA's approach to this part of MiFID implementation. This cannot be to the benefit of the portfolio manager's underlying clients.

#### *Specific issues*

- Para 7.81 appears to deal with the position of portfolio managers currently treated as MCPs, but the wording is unclear and could be interpreted to mean that where a fund manager is treated as an intermediate but the business is

- IPC business, a firm could classify the fund manager as an ECP under MiFID without notification. We assume that this is not what FSA intends.
- The confirmation of the approach to determining whether a person is a "client" is generally helpful, although unfortunately we do not think the position in dealer markets is as clear as it appeared to be in August, following the publication of Chapter 4 of the FSA paper on Client Classification.
  - We still hold the view that firms dealing on a quote driven basis with a portfolio manager will generally also be executing orders on the part of clients (whether or not the portfolio manager is classified as an ECP or a professional client), in line with the indicia set out in FSA's August opinion. However the reference to the service of "facilitating transactions" is confusing as this is not a MiFID investment or ancillary service.
  - The legal opinion published by FSA in October, with CP06/19, is specific that, when dealing occurs in dealer markets, the price taker will be a "non-client" at that point. This does not appear to tie in with the reference to the service of "facilitating transactions". We comment on this in more detail in our response on best execution.
  - The content of paras 7.100 and 7.101 of the Consultation Paper is welcomed in and we would urge the FSA to introduce this as guidance to ensure that market participants take the time to understand the nature of the relationships that they are entering into and improve the clarity of these arrangements .
  - Portfolio managers, in their capacity as clients, welcome COBS 3.7.6G. We believe that this makes it clear that whilst a firm may re-categorise a client on its own initiative, where this requires amendment to the contractual terms already agreed with the client (in terms of reflecting the new categorisation and any other duties which the firm owes to the client which may change as a result), such amendment should be effected in accordance with the terms of the agreement (often consent of both parties is required to amend an agreement). This is also on the assumption that re-categorisation includes e.g. where a firm that has categorised its client under the current regime as an intermediate customer, then decides to treat it as an ECP under MiFID.

### **Position of clients of portfolio managers**

- We welcome and support the wide interpretation of the grandfathering provisions of MiFID. These will greatly ease the burden on our members over the implementation period in respect of existing clients. One area which does not appear to have been addressed however, is the question of how long a firm may rely on classification of an automatically grandfathered client under 71(6) or Annex II.II. This point was raised by IMA representatives at a meeting with FSA in October.
- We are also disappointed that FSA has not provided any clear guidance on the application of the Client Classification regime to institutional investors such as trusts (including charities) and pension funds (including Local Government Pension Schemes). In particular, we understand that the FSA's position is that pension funds (both OPS and LGPS) are per se professional clients. We would urge the FSA to confirm this and to provide further guidance (as indicated in the August paper) in relation to the position of trusts. The suggestion in para 7.47 in

- relation to "other institutional investors" that firms should take a "purposive approach" in this area is not very enlightening.
- Paragraph 7.27 of the CP confirms that the FSA's view is that the firm should include only those financial instruments included in Annex 1, plus cash deposits for the purposes of the quantitative test for elective professional status. As the FSA is taking a purposive approach to its implementation of the client classification regime, it would seem reasonable to be able to include investments held in insurance policies, at least to the extent to which the underlying investments are often financial instruments as defined in Annex 1.
  - From earlier discussion on COBS 3.5.3R(2)(c), we had anticipated further flexibility and guidance on the quantitative test for elective professionals, than that provided by paragraph 7.40. We would urge the FSA to consider this aspect further.

Finally, we would urge the FSA to produce their proposals on non-MIFID business as soon as possible.

**Q16: Do you have any further comments on the application to non-MiFID business of the client categorisation proposals set out in our August CC Paper?**

We have no further comments on this at this stage, other than as set out above and in our response to the August CC.

**Q17: Do you agree with our proposal that the IPC should be deleted from the FSA Handbook?**

Yes. The IPC no longer has a role in MiFID. However, we may wish to comment later about some parts of the guidance that could usefully be retained to clarify some of the MiFID text.

**Drafting comments**

COBS 3.1.3R(2): we believe that the word "otherwise" should be deleted.

COBS 3.1.5G: the inclusion of this piece of guidance is helpful, and enhances the understanding of the rule.

COBS 3.2.3R(3) is helpful in describing trustees as clients. Paragraph 7.37 acknowledges that the 'own funds' definition may not be applicable. However, other questions arise – is the trust an undertaking, or entity; can it be a large undertaking?

COBS 3.5.4R states that the qualitative test should be performed on the person when the client is an entity, whilst the directive text refers to 'small' entity. We assume that this was an inadvertent error. It would also be helpful if 'entity' could be defined or explained, and to how, or if, it might differ from other types of client.

COBS 3.8.2R(1) requires a 'standard form' of each notice to be recorded. It is not clear to what this refers.

Transitionals: COBS TP3.3 is confusing as it would seem to say that there is no need to provide a notification of new client status to a client with whom a firm has conducted "inter-professional business" prior to 1 Nov where the client is categorised as an ECP. Whilst inter professional business can only be conducted with a market counterparty, because of the operation of current COB 4.1.7 this could be interpreted by firms to cover intermediate clients under COB 4.1.7 as well as market counterparties. We assume that this is not intended.

COB TP3.5 – the word "an existing" should be inserted in the fourth line before the word "client" and the "a" should be deleted.

**CHAPTER 8: COMMUNICATION TO CLIENTS & CHAPTER 9: FINANCIAL PROMOTIONS**

See Responses to CP06/20: Financial Promotions and Other Communications.

## **CHAPTER 10: DISTANCE COMMUNICATIONS**

**Q18: Do you agree with our proposals to copy-out and to consolidate DMD requirements into a separate NEWCOB chapter?**

Yes, the new chapter is clearer to follow and more consistent, with less duplication, making it easier for firms to use.

**Q19: Do you agree with our proposal to carry forward COB TP5-2 as a substantive rule?**

Yes, we agree with the FSA that this makes sense.

**Q20: Do you agree with our proposals to delete ECO and to review ECD implementation by incorporating redrafted and relevant ECD text into NEWCOB?**

Yes.

**Q21: Do you agree with our proposal to turn off the consumer contracts derogation?**

Yes, we agree that this is no longer needed.

## **CHAPTER 11: INFORMATION ABOUT THE FIRM, ITS SERVICES AND REMUNERATION**

### **Q22: Do you agree with our proposal to retain the Menu and IDD under Article 4 of MiFID?**

While the proposed simplifications around their use are welcomed, we have previously argued that it was not essential to retain the use of the Menu and IDD for MiFID business. We have commented on this at Q4, and in Appendix 1.

### **Q23: Do you have any comments on our plans to use MiFID requirements as the baseline for our research on possible alternatives to the IDD and Menu?**

No, the proposal seems sensible, as long as it minimises disruption in the transition, and avoids any unnecessary un-levelling of the playing field.

### **Q24: Do you agree with our proposal to retain our rules on range, scope and independence?**

Yes.

### **Q25: Do you agree that our current rules on 'out of range' recommendations are not needed?**

Yes. We agree that the current rule adds little benefit to the process.

### **Q26: Do you agree with our proposals for implementing these additional disclosure requirements from MiFID?**

Yes. We recognise that the FSA has little choice in implementing the rules for MiFID scope business, and welcome their not doing so for non-MiFID scope business.

However, although you state that these requirements will only apply to MiFID scope business (paragraph 11.50) COBS 7.1.4 applies to all retail clients (scope and non-scope). This should be amended to make clear that sub-sections (2), (3), (7), (8) and (9) do not apply to non-MiFID scope business.

COBS 7.1.6R(1) differs from Article 30 of the implementing directive, in that the Article refers to retail and potential retail clients, while the COBS rules appears to apply to all clients. We assume that this is an oversight.

COBS 7.1.10R is also, from our reading of the implementing directive, intended to apply to retail clients.

**Q27: Do you agree with our proposal to delete the excessive charges rules at COB 5.6?**

Yes, this seems to be adequately covered by the principles and market disciplines.

**Q28: Do you have any comments on our approach to statutory status disclosure?**

Yes. We recognise that the FSA has little choice in implementing the rules for MiFID scope business, and welcome their not doing so for non-MiFID scope business.

However, although you state that these requirements will only apply to MiFID scope business (paragraph 11.63) COBS 7.1.4 applies to all retail clients (scope and non-scope). This should be amended to make clear that sub-sections (1) and (4) do not apply to non-MiFID scope business.

It might be helpful for guidance to note that this information need not be included on a business card

## **CHAPTER 12: INSURANCE MEDIATION**

**Q29: Do you agree with our proposals to re-implement the COB Insurance Mediation Directive provisions in NEWCOB 8?**

We have no comments to make at this stage.

## **CHAPTER 13: CLIENT AGREEMENTS**

### **Q30: Do you agree with our proposal to copy-out MiFID client agreement proposals into NEWCOB and not add additional COB-based requirements?**

We support the FSA's proposals to avoid adding additional COB-based requirements, and instead to copy-out the MiFID client agreement proposals.

However, the annexes to COB 4 act as a useful checklist for firms of the matters that need to be notified to clients or agreed prior to providing services. We would encourage FSA to consider producing a list of the different consent and notification requirements under COBS, to act as a checklist for firms both before they undertake any business, and on an ongoing basis.

## **CHAPTER 14: IDENTIFYING CLIENT NEEDS AND ADVISING**

### **Q31: Do you agree with our proposal to use the MiFID requirement as the nucleus of the NEWCOB 10 regime?**

We agree that the MiFID requirements should form the nucleus of the NEWCOB10 regime. However, we consider that this highlights once again the problems faced by FSA and the industry in the continuation of the 'packaged product' regime in its current form. We have recently submitted a paper containing our thoughts on this regime, and this is attached as Appendix 2.

### **Q32: Do you agree with our approach to carrying forward a modified requirement for an explanation to retail clients of the reasons for a recommendation (the proposed 'suitability report')?**

We support the continuation of an explanation to retail clients, using the proposed suitability report.

### **Q33: Do you agree with our proposed approach to integrating the relevant provisions of the IMD in NEWCOB 10?**

We support this approach.

### **Q34: Do you agree with our proposal not to extend the application of the detailed suitability requirements to professional clients beyond what MiFID (or IMD) requires?**

We agree with your proposal.

### **Q35: Do you agree with our proposed position on Basic Advice?**

As representatives of the investment management industry we do not have any comment to make on this point.

### **Q36: Do you agree with our decision to have a wider review of Basic Advice? If so, do you have any views on the remit of the Review?**

As representatives of the investment management industry we do not have any comment to make on this point.

## **CHAPTER 15: NON-ADVISED SERVICES**

We support the FSA's intention to limit the Appropriateness Test to MiFID-scope firms conducting MiFID-scope activities. While problems and questions will still arise for some firms in some circumstances, as set out below (Q37), the exclusion of CIS operators from the regime is to be welcomed.

### **Q37: Do you see any points of uncertainty in how the MiFID appropriateness requirements may apply to your business model(s)? If so, what?**

The circumstances in which a communication becomes 'personalised' is, ultimately, going to be dependent on individual cases, however, it would be helpful to have greater clarity than exists currently. Paragraph 15.26 states that an appropriateness test will not be required if the communication does not refer to the personal circumstances of the client. Referring, in a letter to an existing client, to their status as clients would not, we suggest, lead the recipient to understand that the personal circumstances of that client have been considered in issuing that letter. We believe that the critical issue is whether the client believes that he or she is the recipient of a recommendation, of advice.

COBS11.4.1R(3) sets out the test of whether a financial instrument is non-complex. It would be helpful if the FSA could provide some guidance on certain of the products that do not automatically qualify as non-complex (COBS11.4.1(2)). For example, we would assume that most, if not all, non-UCITS retail schemes would be able to qualify as non-complex, but a definition of, for example "frequent opportunities" would seem to be critical.

If firms were to be required to undertake appropriateness tests there would be significant cost and system implications. Additional information would need to be gathered, assessed and recorded. Subsequent use of that information would have to be re-considered (for how long would information be valid?) These could easily require the use of staff skilled in the understanding of the requirements set out in COBS11.2.1 and 2.

Clarification is required as to the position for Child Trust Funds. We had understood that the Treasury was intending to look at ways in which it might be able to CTFs invested in CIS from being brought within the MiFID scope, and hence the potential requirement for an Appropriateness test to be undertaken. In particular, we hope that the treasury's paper will look at the position of CTF Revenue Allocated Accounts.

### **Q38: Do you agree with our decision generally not to extend the appropriateness requirement beyond what MiFID requires?**

We agree with the decision, but note that this detracts from the attempt to create a level playing field.

**Q39: Do you agree with our proposal on application of the appropriateness requirement to the specified financial promotions of derivatives and warrants?**

We have no further comments on this at this stage.

**Q40: What are your views on the possibility of extending the appropriateness test to all non-advised retail transactions of derivatives or warrants?**

We have no further comments on this at this stage.

## **CHAPTER 16: DEALING AND MANAGING**

IMA has provided its views on the Best Execution obligations and requirements direct to FSA at some length already over recent months.

Here we comment first on the position of investment managers accessing dealer markets, next on the legal opinion published in October by FSA with CP06/19 in relation to best execution, thirdly we re-present proposals put forward by IMA in July/August on best execution and lastly we answer the questions posed by FSA and make several comments about the proposed NEWCOB text.

### **Investment managers accessing dealer markets**

1. FSA has set out its revised position on the application of the best execution provisions in dealer markets in paragraphs 16.24 - 16.34 and in an FSA legal opinion published with the CP. We respond as follows:
  - We do not agree with the October opinion published by FSA and do not think it is a credible reading of MiFID. It follows that we do not agree with the CP text. We comment in the next section on what we perceive to be the deficiencies of the legal opinion that underpins the CP text;
  - Specifically, the October opinion seeks to remove regulatory protections for asset managers, as clients of the market, that MiFID provides – principally the Article 18 protection that requires a broker to manage his conflicts of interest when dealing with clients but also, perhaps more seriously, the protection of the client assets rules. In consequence, we believe that FSA, if it proceeds on this basis, will have failed to implement MiFID;
  - Our view is unchanged (from previous correspondence) that, under MiFID, the investment manager will always be a client of the broker/dealer. An investment manager goes to a broker/dealer to give effect to his investment management decisions, on behalf of his clients. In this capacity his actions are not comparable to those of dealers in the inter-dealer market. For example, unlike a dealer he is not dealing on his own account. He neither has the dealer's conflict of interest, nor does he have the dealer's capacity or discretion to act other than in the sole interests of his client.
  - We have serious concerns about the process that FSA has followed in reversing its opinion on whether dealers undertake an activity or a service under MiFID (which determines whether a client relationship is created). We consider this to have been a non-transparent process in an area that FSA knew was highly contentious within the market. This would matter less were the outcome – the October opinion - not so biased in favour of one market group over another. We have moreover been hampered in

providing this response by FSA's failure to publish the responses to its May DP 06/3 on best execution.

- Acting in the belief that MiFID imposes the duty of best execution on dealers when dealing with professional or retail clients, we put forward a proposal for how this obligation could be interpreted in our response to the May DP. We presented this at the 21 July FSA Roundtable on best execution to a favourable response from other market participants. We continue to await a considered response from FSA.
- Also, we consider that the FSA should re-visit what is termed the 'specific instruction argument'. No single approach is without its own difficulties. However, this could provide an appropriate way of dealing with the difficulties surrounding the provision of best execution by firms that deal on own account, whilst at the same time properly retaining the client status of entities that do business with dealers.
- Paragraph 16.4 of CP06/19 states: *'MiFID's best execution requirements have two main policy objectives: client protection and market efficiency. These measures are intended to protect customers by addressing information asymmetries and potential conflicts of interest between investment firms and their clients...'* From an economic perspective we believe that the effect of the October opinion is that FSA will fail to meet either of these objectives. We have written separately about this.

2. We point out that the consequences of FSA's reversal of opinion include:

- The only reasonable way of viewing the practical effect of the October opinion is that it removes dealer markets, at the point of dealing, out of regulatory scope and therefore puts what goes on between the participants into the commercial domain;
- The only way offered by FSA for participants to come back into regulatory protections is to seek full service best execution. This may come at high cost. We add that best execution, in particular as this relates to price, is not something that is always a required service;
- From a practical perspective this means that asset managers which do not want full service best execution will need commercial agreements with each of their brokers to reinstate the other protections that they need – principally those that relate to the management of conflicts of interest and to client order handling i.e. to prevent front running. This will create significant levels of paperwork and cost and also the on-going headache of keeping the agreements up-to-date. None of this has been reflected in the cost-benefit analysis presented by FSA;
- Such arrangements will have to be in place by November 2007 as no transitional relief has been (indeed can be, if the non-client view persists)

offered to investment managers in relation to their classification as clients of the market. This imposes a further heavy burden on investment managers at a time when they will also be working to bring in new paperwork and procedures in relation to their own underlying clients;

- We are not clear what consequences flow from the removal of client status at the point of dealing as this relates to client assets. One consequence could be that the assets that are the subject of the deal – cash or securities – cannot be client assets as client status is lost at the point of the deal being struck. If this were to be the case, the protection of the client assets rules would appear to be lost, thus leaving the client unprotected in the event of insolvency. This issue cannot be resolved contractually. FSA guidance is therefore sought;
- Lastly – and to quote Mr Tiner's reference to 'that lucky dealer' not being subject to the best execution obligation<sup>2</sup> – the FSA's reversal of opinion acts to shift the entire burden of evidencing best execution to the client of the market, in this case the investment manager. This appears to fly in the face of all the FSA and CESR work on the 'execution chain' during Spring 2005. Nor has the FSA sought to deal in the CP with the challenges that this about-turn presents to investment managers. This compares with the work that was undertaken (albeit rejected) in DP06/3 to find means by which dealers might evidence best execution.

### **The FSA's October legal opinion**

3. We consider that the legal opinion has a number of deficiencies that undermine its effectiveness in supporting the FSA's policy position on best execution in dealer markets.
4. Specifically:
  - The propositions presented in the first section of the opinion, Paragraphs 2 and 3, are not supported by the following text, in that the text wanders into subject areas that are not alluded to in the propositions.
  - The most egregious example is the leap of faith represented in Paragraph 13 of the opinion in which FSA states that 'A client can choose ... to seek a range of quotes without giving an order, and take the best execution responsibility himself, effectively acting as a non-client on that transaction'. We dispute that there is any connection between the decision not to seek best execution and the apparent conclusion drawn by FSA that this removes client status. Client status is determined by virtue of the nature of the relationship between the parties and not by the delivery or otherwise of best execution.

---

<sup>2</sup> Keynote speech by John Tiner to the British Bankers' Association 10<sup>th</sup> Annual Supervision Conference, 11 October 2006 (*UK's Leading Role in the Adoption of International Initiatives*)

- Moreover we dispute the conclusion apparently drawn by FSA that would indicate that the act of agreeing a price with a dealer is separable from other contact between the parties in the same market. It is simply not credible to suggest that contact between an investment manager and the sales trading desk of a dealing firm will encompass a client relationship, but that the act of accepting a price from the employee running the book will not.
  - The opinion also fails to address the very real practical issue of how a dealing firm will be able to draw a line between its client and non-client business, affording protections to the one and not to the other. How, for instance, can conflicts of interest be managed in relation to client contact with a sales trader, but ignored when the (non) client accepts a price?
  - The second bullet point of paragraph 2 is unclear. Whilst the '*general duty of best execution*' may apply '*only in the course of providing a service to a client*' the rest of the sentence is a non sequitur.
  - The effect of the opinion is to introduce unnecessary uncertainty between market participants. This is unfortunately exacerbated in the section on Interaction with Client Classification. Paragraph 21 appears to offer some relief to clients as they take a price and cross the line to become non-clients. But since the final sentence confirms the removal of the benefit of the client order handling obligation, the practical effect is to take away one of the principle protections offered to a market user when he deals with a market intermediary.
5. We therefore consider that the FSA would be better advised to re-visit what is termed the 'specific instruction argument', drawn from MiFID Article 21(1). FSA could, for instance, explore the opportunities available in dealer markets for determining when, as a matter of market practice, instructions are considered to have been provided by clients, and what the extent of these instructions may be. This approach would, as already mentioned, have the virtue of allowing clients to do business within the regulatory environment clearly envisaged by MiFID (where conflicts of interest have to be managed and protection may be sought in respect of client order handling). At the same time it would respond to the concerns about the duty of best execution expressed by firms dealing on own account.

### **Another way of delivering best execution in dealer markets**

6. We present here, for further consideration and response, the proposal that we put forward for handling the duty of best execution in dealer markets. We made a presentation on the proposal at the 21 July Roundtable on best execution organized by the FSA and note that it received a favourable response from many participants at the Roundtable. We submitted this written proposal to FSA in August in response to DP06/3 – since when we have heard no more.

### *The proposal*

7. This proposal takes account of the following points:
  - Our members wish to keep the markets running much as they do today as they perceive that the markets serve their needs well and are generally competitive;
  - That the MiFID text imposes a duty of best execution on dealers, in some circumstances, and that therefore when executing a client order the dealer will have to offer best execution to professional and retail clients;
  - The need to suit the best execution obligation as it applies to dealers to the particularities of different markets, and instruments; and
  - The reality that best execution is a process divided between the firms involved in the execution chain.
8. MiFID acknowledges that the best execution obligation may apply in many different ways<sup>3</sup>. This is a key acknowledgement for non-equity markets and instruments.
9. A particular problem for dealers is that although they have access to valuable client order flow information, amongst other things, they are not able, given the structure of dealer markets, to shop around for product amongst other dealers. They cannot, in a nutshell, replicate the services of an agency broker. This implies to us that the only realistic way to view the dealer is effectively as an execution venue (which would be the case in equity markets in respect of systematic internalisers). The corollary to treating the dealer as an execution venue is that he should be obliged only to consider his own execution quality, not that of other dealers.
10. In MiFID terminology, this would suggest that the best execution factors to be taken into account by the dealer, when delivering best execution to a client, could include speed of execution, size of order and nature of instrument, but are unlikely to capture price relative to competitors. Thus whilst the dealer will wish to describe in his policy the approach he takes to pricing securities, specifically he will not have to factor in the prices quoted by his competitors. This reflects the dealer's position in the chain of execution.
11. Importantly, however, the dealer would, in setting out his execution policy, also have to deal with his conflicts of interest in relation to the execution of trades. Given the provisions of Article 18 of MiFID Level 1, this would be the case regardless of whether the client had taken eligible counterparty or professional/retail status. It would be a matter for the dealer to establish what conflicts could impact on treating his client fairly, or be abusive, and decide explicitly how these should be managed. Managing conflicts of interest could, for instance, prevent a dealer from taking, undisclosed, both a spread and a

---

<sup>3</sup> Level 2 Directive, Recital 70 '*... Best execution obligations should therefore be applied in a manner that takes into account the different circumstances associated with the execution of orders related to particular types of financial instrument.*'

commission from matched customer orders. It could ensure that the dealer did not discriminate in terms of execution quality between clients other than on objective criteria, which could be incorporated in his execution policy. It could prevent client-specific order flow information being used to the disadvantage of that client, for instance by trading ahead on the proprietary book whilst the client's order was being worked. To the extent that the dealer was unable to resolve these issues, disclosure could in some circumstances be made to the client, thus permitting the client to choose whether to proceed or not.

#### *Implementation by FSA*

12. We therefore propose that FSA should approach best execution by 'copying out' the MiFID Level 1 and Level 2 text and providing some limited additional guidance:

- firstly, to reiterate the underlying principles that apply to all dealers when executing client orders, regardless of the instrument or market they deal in: referencing FSA Principle 8 – conflicts of interest (as this will in most circumstances also apply to eligible counterparties under MiFID), Principle 5 – proper standards of market conduct - and Principle 6 – treating customers fairly (as this applies to professional and retail clients); and
- secondly, to indicate briefly the factors that might be taken into account by dealers when executing client orders, along the lines suggested above. Alternatively, this latter guidance could be issued by MiFID Connect.

#### *Enforcement of best execution*

13. The MiFID best execution obligation rests on the firm, but the intention behind the provisions is also to give customers better tools to ensure that they get best execution. In addition, however, an obligation also rests on the regulator to ensure that the rules are enforced (including firm's own compliance arrangements). This would be particularly the case in decentralized markets in which there is little trade transparency. There is every reason, given the FSA's supervisory reach and its collection of transaction information, for the FSA to play a part in checking execution quality in such markets, over and above the checking and challenging that a customer may opt to do. This would provide further objective support for the efficacy of the rule.

#### **Q41: Do you agree with our proposal to copy out MiFID's Best Execution requirements in January 2007?**

- a. The IMA agrees that intelligent copy out is in principle the appropriate method of implementing MiFID measures into the UK regulatory regime. We do not believe that the proposed CP text achieves this aim. This is because there still remains considerable uncertainty about when and in what circumstances client relationships are created in dealer markets.

- b. If the FSA deems that investment managers fall under Article 21, Level 1, in dealer markets, then IMA members would be required to demonstrate to their clients that they have executed their orders in accordance with the firm's execution policy. IMA members are unclear as to what data points the FSA would require to see and are unsure as to how to construct data collection systems beyond those that are already in place. We of course anticipate that existing systems would evolve over time. However, we remind the FSA that it is not possible to construct reliable reference data if there is little or no post-trade transparency, for example as is currently the case in cash fixed income markets. In these circumstances we assume that the FSA would be prepared, in line with its stated objective to ensure continuance of existing market arrangements, to accept existing practices developed by investment managers for ascertaining best execution. Moreover we assume that an adequate approach for constructing the best execution policy could encompass a review of current arrangements, and prospectively, a continuation of these if they appear to the investment manager to represent the best he is able to do for his clients post-MiFID. FSA's view of this approach needs to be made known.
- c. In addition, the investment manager does not necessarily see all the information that a broker would see and use for his own evidencing. Therefore how does the FSA envisage that the investment manager obtain that data from his broker? Is there some way that duplication of data collection by both the buy and sell-sides can be avoided? The IMA urges the FSA to provide some guidance as to the implementation of Article 21 (5) for asset managers.

**Q42: Do you agree with our proposal to add guidance on the role of price in Best Execution?**

We agree.

**Q43: Which of the three options in relation to Best Execution for UCITS portfolio managers creates the most appropriate and proportionate regulatory regime? Why?**

We anticipate that UCITS portfolio managers will have one execution policy, and as many such firms are within a group, including an in-scope asset manager, we believe that there will be little attraction in maintaining separate best execution policies.

However, there is an implication, not borne out by COBS 12.1.1(R), that the MiFID best execution requirements would apply if the CIS manager was itself managing the assets. The UCITS portfolio manager is only included in MiFID to the extent that it is carrying out activities not related to its CIS manager function.

COBS12.1.1R makes it clear that COBS 12 does not apply to a CIS firm, and will only apply to a UCITS portfolio manager to the extent that it undertakes MiFID business. In those circumstances, the firm will, for that portion of its business, be subject to COBS 12 in exactly the same way as any other discretionary investment manager.

**Q44. Do you agree with our analysis that the risk of client detriment from the removal of the prescriptive rules in COB concerning 'prompt' allocation of client orders is small given other MiFID provisions?**

We believe that the removal of prescriptive rules reduces the risk of client detriment. We are pleased that the ability to 'warehouse' trades for private customers is recognised for the potential advantage that can derive to customers.

A flexible definition of 'prompt' is key to enabling firms to take account of the particular circumstances, and the text in paragraph 16.61("as soon as reasonably possible depending on the circumstances") is of assistance.

It might be helpful to include this explanatory text in the rules, or otherwise to come to some consensus as to the definition of prompt, and therefore some clarification from the FSA would be welcomed.

**Q45. Will the MiFID requirement for prompt delivery after settlement present any material operational difficulties for your business?**

We do not anticipate that this requirement should present any material operational difficulties.

**Q46. Do you agree that clients may benefit from later allocation because it allows firms to minimise clients' transaction costs and/or because it allows clients to participate in average pricing? Can you provide specific examples?**

We do believe that clients may benefit from such later final allocation, in the way that you describe.

**Q47: Do you require any further clarification or guidance on the obligation to publish client limit orders?**

No. However, it would be helpful if part of the CP text was incorporated in the Handbook as guidance, specifically paragraphs 16.82, 16.83 and 16.84 which expand upon the position of 'stop orders' and 'contingent orders'. It is not reasonable to expect market participants to refer back to CP text.

**Q48: Are there any other types of order which should also be excluded from the definition of limit orders?**

Not that we are aware of at present.

**Q49: Do you agree that we use the power to waive the requirement to display client limit orders to the public in respect of limit orders larger than NMS?**

Yes, we agree.

**Q50: Do you agree with our proposal to copy out the MiFID personal transaction requirements and to apply them to non-MiFID business?**

We agree that it seems sensible to apply the requirements to non-MiFID business, even though this does extend the scope of those subject to these requirements. The extension of these requirements, via the definition of relevant persons, to employees of companies to which functions are outsourced is a significant change. Especially where that outsourcee firm is not currently regulated, there is the potential for significant cost implications. However, we were pleased that the final requirements did not extend to the prompt passing back of the information to firms.

We note that the requirements need only be imposed on those who are, or might be, involved in activities that may give rise to a conflict of interest or who have access to particular information. This should give firms some discretion to apply a policy that reflects the risk. COBS 12.7.5R excludes discretionary portfolios, UCITS and life policies, but firms specialising in particular areas could well choose to exclude other instruments – as not creating any conflict of interest. We anticipate that firms will take account of the precise wording, in order to make the requirements more focused and relevant to the actual activities of the individuals and the firm.

COBS 12.7.5(2) includes the phrase ‘involved in the management of that undertaking’. We assume that this is meant to be drawn narrowly, and with consideration of the potential for conflicts of interest, but it would be helpful if FSA could provide some clarity.

**Q51: Do you agree with our proposal to carry forward the use of dealing commission provisions in NEWCOB?**

While carrying forward the FSA’s provisions regarding the use of dealing commissions is not a requirement under MiFID, the IMA believes that it is appropriate to do so. Asset managers have installed systems and processes to comply with the use of dealing commission regime and have already incurred substantial costs. To do away with the regime would likely be counter-productive at this point in its evolution.

**Q52: Are there any aspects of COB 7.10 that in your view should be retained in NEWCOB? Would any of these provisions be more appropriately expressed as industry guidance?**

We have no comments to make at this stage.

**Other comments:**

A MiFID investment firm involved in the sale or redemption of units may be requiring best execution on those trades. When dealing with the CIS manager, usually the sole venue (at least in the UK), the existing provisions of COLL ensure that the instruction is given effect to at the best (correct) price and in a timely fashion. We do not believe that any further regulation is required in this area.

However, we are aware of the potential for issues to arise if, for example, the CIS was also to be a listed entity. In those circumstances we would suggest that dealing with the CIS manager was not going to be a 'best execution' issue; that firms would not be required to identify whether there was an alternative market in the CIS units.

**CHAPTER 17: INVESTMENT RESEARCH**

**Q53: Do you agree with our proposed approach to implementing the MiFID requirements on research?**

The IMA agrees with the FSA's approach to implementing MiFID requirements on research.

**Q54: Do you have any comments on our discussion of the labelling and dealing ahead issues in relation to non-independent research?**

The IMA has no comments with regard to non-independent research.

## **CHAPTER 18: PREPARING PRODUCT INFORMATION**

### **Q55: Do you agree with our proposals to improve KFDs rather than implement QG?**

We welcome the decision to abandon the QG at this stage, and we look forward to a radical review of the disclosure regime. We also welcome the decision to remove the requirement for the Simplified Prospectus to include the Reduction in Yield calculation.

We assume that firms may continue to produce combined KFDs/SPs, which may also include ISA wrapper information.

### **Q56: Do you agree with the way we propose to implement the MiFID disclosure requirements?**

We support these proposals.

### **Q57: Do you have any comments on our proposal to move from our current standardised approach to projections to the MiFID standard for MiFID business?**

We support this development.

### **Q58: Do you agree with our proposal to introduce the keyfacts logo and regulatory message?**

We support the continued use of the Simplified Prospectus as the document of choice for all UCITS, and for the vast majority of non-UCITS retail schemes.

If a firm was to include ISA wrapper information with the SP, this may be regarded as a KFD, and thus require the keyfacts logo. This seems to be an unnecessary addition to the requirements.

### **Q59: Do you have any comments on the other proposed policy changes to our disclosure requirements?**

We have no further comments on this at this stage.

### **Q60: Do you agree with our proposed principles-based approach to disclosure as reflected in our draft Handbook text?**

We fully support the FSA's move towards a principles-based approach.

### **Q61: Do you agree that the changes we propose will make our disclosure requirements easier to follow?**

We believe that the proposed changes mark a good start on what should be a more radical review.



## **CHAPTER 19: PROVIDING PRODUCT INFORMATION TO CLIENTS**

**Q62: Do you agree with our proposed changes to the current rules and guidance in respect of providing product information to clients?**

We have no further comments on this at this stage.

**Q63: Do you agree with our proposal to copy-out MiFID rules on customer understanding of risk, and delete the existing rules and guidance?**

We support the proposals.

## **CHAPTER 20: CANCELLATION**

**Q64: Do you agree with our preferred option to extend existing cancellation rights to all advised non-life products?**

Yes, this is the simplest solution, ensuring an easily understood, level playing field. The increase in cancellation rights is effectively limited to non-life products (although not CISs, ISAs, CTFs or EISs) which are not sold through distance contracts.

**Q65: Do you agree with our proposals to maintain the current cancellation requirements for all life and pensions products (other than SIPPs)?**

Yes, the FSA has to implement the requirements of the CLD and DMD.

**Q66: Do you agree with our proposal to extend the CLD requirement for pre-sale disclosure of cancellation rights for non-distance (non-life) contracts?**

Yes.

**Q67: Do you agree with our proposal to remove the requirement to send a post-sale cancellation reminder notice?**

Yes.

## CHAPTER 21: REPORTING INFORMATION TO CLIENTS

Rules 17.3.2 and 17.3.3 both refer to a client being able to 'elect' to receive different standards of 'periodic reporting'. Is it sufficient that appropriate wording is in the client agreement or does this have to be at the client's initiative?

COBS 17.2.1(5) refers to activity by a MiFID firm in relation to collective investment undertakings: could the FSA confirm that these would include Investment Trust Savings Schemes, PEP/ISAs and OPS activity, and that they would thus, only need to report to clients on a six-monthly basis? We assume that the existing ability of CIS operators to issue annual statements will continue. In particular, we note COBS 17.3.9(R)2 in relation to CTFs, which therefore includes CTFs that are invested in CIS units.

There is no provision in COBS 17 equivalent to COB 8.1.11 allowing for the provision of essential information at a future date which has not been provided to the firm by a third party.

Is 17.2.6 missing for a reason? Is something to be inserted here?

There is no reference in NEWCOB to the provision of information regarding any accrued interest that may be included in the price of a fixed income product (i.e. the difference between the clean and the dirty price). In COB it was 8.1.16(4).

NEWCOB does not require the transaction report to state whether a deal was executed on a historic or forward price.

Annex 1 R(1) refers to SUP17 Ann 1 – is this correct?

- Subsection 4 refers to the trading time: could the FSA confirm whether this would be the time that the deal is executed

Annex 1 R(2) does not include a reference to movements of cash in or out of the portfolio over the reporting period. Without this it will not generally be possible to get the periodic movements to balance.

It is also included twice.

**Q68: Do you agree with our proposals to retain the existing COB requirements set out in paragraph 21.8?**

We do not object to the retention of these requirements

## **CHAPTER 22: CLAIMS HANDLING FOR LONG-TERM CARE INSURANCE**

**Q69: Do you agree with our simplified rules on long-term care claims handling?**

We have no comments to make on the simplified rules.

## **CHAPTER 23: SPECIALIST REGIMES**

### **Q70: Do you agree with our proposals for MiFID trustee firms?**

Yes, provided that the FSA stick to the carve-out stated in footnote 71 on page 145, so that the proposals do not affect trustees and depositaries of collective investment undertakings that are exempt under Article 2(1)(h) of MiFID.

### **Q71: Are there any aspects of the 'permitted third party delegation' (PTP) provisions which are not inconsistent with MiFID that you consider it would be useful to retain?**

We have no comments to make at this stage.

### **Q72: Do you agree how we propose no longer to apply the current conduct of business concessionary provisions to the MiFID business of firms under the regimes for energy and oil market activity, corporate finance business and stock lending?**

Yes. We recognise that the FSA has little choice in applying the rules to MiFID scope business, and welcome their not doing so for non-MiFID scope business.

However, although you state (in paragraph 23.32) that the applicable parts of COBS, those derived from MiFID, may not apply for stock-lending between ECPs, the actual text of COBS 19.4.2 states that the rules are dis-applied for all MiFID business (and equivalent business from a third country investment firm), no mention of this being limited to inter-ECP stock-lending.

The elements of COBS which are to be dis-applied for inter-ECP stock-lending business should be made more clear.

### **Q73: Do you agree with our proposal to include guidance that will replicate the effect of the current corporate finance contact and venture capital contact exclusions?**

We have no comments to make at this stage.

### **Q74: Do you agree with our proposal no longer to prescribe the form of the risk warning that a firm should provide to a customer in relation to RSDs?**

We have no comments to make at this stage.

## **CHAPTER 24: WITH-PROFITS**

**Q75: Do you have any comments on our proposals to adopt a more high-level approach in NEWCOB for the existing with-profits material currently in COB?**

We have no comments to make at this stage.

## **CHAPTER 25: PENSIONS: SUPPLEMENTARY PROVISIONS**

**Q76: Do you agree with our proposal to continue with the rules on pension transfers, simplified as proposed?**

We have no comments to make at this stage.

**Q77: Do you agree with our proposals for product disclosure in respect of occupational pension schemes?**

We have no comments to make at this stage.

**Q78: Do you agree with our proposal to de-regulate stakeholder pension decision trees?**

We have no comments to make at this stage.

**Q79: Do you agree with our proposal for open market options?**

We have no comments to make at this stage.

## **CHAPTER 26: TRANSITIONAL PROVISIONS AND WAIVERS**

**Q80: Do you have any comments on the proposed approach to NEWCOB transitionals and waivers?**

We have no further comments on this at this stage.

**Q81: Are there any areas, other than those mentioned in paragraph 26.10, where you think it would be helpful to make transitional provisions?**

We have no further comments on this at this stage.

**Q82: In which areas, if any, do you think it possible that you may need to apply for waivers?**

We have no further comments on this at this stage.

## **CHAPTER 28: UNFAIR COMMERCIAL PRACTICES DIRECTIVE**

**Q83: Do you have any comments relating to the implementation of UCPD for financial services?**

## **CHAPTER 29: MIFID ORGANISATIONAL REQUIREMENTS NOT COVERED IN CP06/9**

### **Q84: Do you agree with our proposals for a high-level recordkeeping requirement for common platform firms?**

Yes, we agree that the high-level record-keeping requirements for common platform firms make sense.

We note with approval that the FSA intend to maintain their practice of setting out the detailed record-keeping requirements for each module of the Handbook in a Schedule at its end (paragraph 29.17, SYSC 9.1.6).

### **Q85: Do you agree with our proposals for implementing the MiFID requirements for the outsourcing of portfolio management services to retail clients to service providers located outside the EEA?**

We recognise that the FSA is compelled by the implementation of MiFID to put these conditions and processes in place, however, we have a number of comments on the detail of the proposals for implementation.

### **Q86: If you do not agree, what would you change?**

We think that it should be made clearer that the requirements do not apply to secondary outsourcing via another MiFID investment firm. SYSC 8.3.1 states that the *guidance* in SYSC 8.3 applies to outsourcing, whether directly or indirectly. The only *rule* in this section, SYSC 8.2.1, does not apply itself to secondary outsourcing. Where a UK firm (FM) has outsourced retail portfolio management to another EU portfolio manager (EU O/S) and that firm has then outsourced retail portfolio management to a non-EEA firm (Non-EEA O/S) we hold that the responsibility for complying with the requirements of SYSC 8.2 and 8.3 fall on the EU portfolio manager (EU O/S). The UK firm should only need to comply with SYSC 8.1 (which implements Article 14(2) of the Level 2 Directive). We consider that this issue should be clarified.

We think that some of the due diligence requirements in SYSC 8.3, particularly 8.3.7(1) and 8.3.8(1) will require firms to effectively provide legal opinions on the regulatory regime of the firm to which they are seeking to outsource.

Although the general outsourcing rules refer to a lighter touch where the outsourcing firm has some control over the outsourcee and this should also apply here, it would be useful to have this stated explicitly in relation to outsourcing of portfolio management as well.

Whilst we welcome the FSA's proposal to list non-EEA states with whom they have appropriate co-operation agreements, it would be extremely useful if the FSA could also provide information indicating which regimes would (or would be likely to) comply with

SYSC 8.2.1(1)(a), regarding authorisation and prudential supervision. The more detail in this area that the FSA can provide, the less the burden this set of rules, which you yourselves would rather not apply (paragraph 29.36 of CP text), will impose on firms.

In SYSC 8.3.4 the use of the word "adequate" is a hostage to fortune - "appropriate" or "suitable" would be better.

In SYSC 8.3.7(5) - the firm cannot "ensure" that the service provider prepares annual reports and accounts. It can only require that the provider do so.

SYSC 8.3.7(7) should also be deleted - there is sufficient comfort in SYSC 8.1 and in SYSC 8.3.7(8). A firm will not be able to supervise the control of confidential information. It will be able to insert provisions regarding protection of such info into the agreement. No convincing rationale is provided for this proposal.

We consider that where the FSA issue a supervisory notice preventing a firm's outsourcing plans, that this should be limited to the particular firm proposed. We do not think that the FSA should ever prevent a firm from outsourcing to any firm in a particular country (as is indicated in paragraph 29.45 of the CP). This would, in any case, be unnecessary, as should the firm wish to outsource to a different firm in the same country they would have to make another notification to the FSA, which they should then consider on all its merits.

**Q87: Do you think that the matters we propose to set out in the policy statement on which we would require to be satisfied in order not to object to a prior notification are appropriate?**

They seem, other than as indicated above, to be the things that a firm should be ensuring as part of its standard due diligence process anyway.

**Q88: Do you think that any of the matters set out in the policy statement will be disproportionately difficult for firms to comply with?**

The requirement in SYSC 8.3.7(1) and 8.3.8(1) for firms to 'assess the extent of overseas regulations'.

## **CHAPTER 30: TRAINING AND COMPETENCE: MAKING THE SOURCEBOOK MIFID-COMPLIANT**

**Q89: Do respondents agree with our proposal to disapply all of the existing TC rules for inwardly passporting EEA MiFID firms and deal with any implications as part of the wider review?**

In order to comply with MiFID, FSA have no discretion but to disapply all of the existing TC rules for inwardly passporting EEA MiFID firms. We do agree that it would be sensible to consider the implications of this as part of the wider T&C review in February 2007. Whilst there may be competition issues for some of our members we don't believe these to be significant. However, we would be interested to receive the results of FSA's recent survey into the possible issues of creating an un-level playing field and the extent of any potential competition issues.

**Q90: Do respondents have any views on the potential competition issue between UK firms and inward passporters in terms of its likely extent and the nature of its impact on firms or other stakeholders and whether any changes are necessary?**

Our members are unlikely to be greatly affected by competition issues as a result of this change. Although few EEA member states have compulsory exams, many IMA member firms wish to preserve the examination element of their T&C schemes and consider that this puts them at a competitive advantage within the industry and, in particular, in maintaining high standards to customers.

**Q91: Do you agree with our proposal to remove the current requirements for passing exams within specified time limits (and the associated record-keeping guidance) for both MiFID and non-MiFID firms?**

We agree with this proposal. We think it sensible to remove the time limits for both MiFID and non-MiFID firms to ensure a consistent approach across the industry. Many of our members already impose their own time constraints on staff passing exams as part of their study policy, or rules concerning probationary periods. This reflects the need to reduce supervisory costs and ensure that staff can be assessed as competent in the job within a reasonable period. We agree that what is reasonable should be determined by a firm's senior management.

**Q92: Do you agree with our proposal to amend the record-keeping retention requirements in the TC Sourcebook to five years for MiFID business only?**

We agree with this proposal. Many of our members already retain records for five years or more. There may be issues around separating out different record keeping requirements between MiFID and non-MiFID business and firms will need to consider their system requirements. Some firms may decide to extend their T&C record keeping

requirements to five years for all business functions to retain a consistent approach. We look forward to considering the wider implications of extending the record keeping requirements for non-MiFID firms as part of the wider T&C review.

**Q93: Do you agree with our proposed minor rule amendments which are required to align TC with the rest of the Handbook as regards the proposed new client categorisation regime and to remove references to private customers which are no longer needed?**

We agree with the minor rule amendments resulting from changes to the new client categorisation and the need to remove references to private customers.

## **CHAPTER 31: DISP (DISPUTE RESOLUTION)**

**Q94: Do you agree the draft New DISP text provides a better focus on the key aspects of fair and timely complaint resolution?**

Yes, this should enable firms to focus on the important aspects of settling consumer complaints, rather than arbitrary deadlines.

**Q95: Do you agree with us removing: a] the five-day requirement for acknowledgement; b] the four-week requirement for a holding reply; and changing c] firms' publicising obligations?**

Yes, we agree with all three of these proposals.

**Q96: Do you agree with our proposed approach on complaint handling and record-keeping for: a] MiFID firms' MiFID business; b] MiFID firms' non-MiFID business; and c] non- MiFID firms and CCJ and VJ participants?**

Yes, this does seem proportionate.

**Q97: Do you agree with the proposed change to the DISP criteria for 'eligible complainants'?**

Yes.

**Q98: Do you find the application provisions sufficiently clear? Can you suggest a better presentation for them?**

The table provided does help clarify the application of the rules.

**Q99: Do you agree with our view of straightforward transition to 'New DISP', or are there complications we have not allowed for?**

We have not identified any unintended consequences yet.

## **CHAPTER 32: TRANSACTION REPORTING REQUIREMENTS FOR NON-MIFID FIRMS**

**Q100: Do you think that our proposed approach contains sufficient Handbook guidance for firms to determine whether they should:**

**(a) report transactions to us; or**

**(b) approach us for individual guidance on their reporting obligations?**

**If not, then what further guidance do you think our Handbook text should contain? Do you think it would be more appropriate for this guidance to go in our Transaction Reporting Users Pack?**

We have for some time been in debate with FSA over the scope of the transaction reporting requirement under MiFID and in particular whether it applies to investment managers. It is disappointing that the FSA makes no reference to this, as we and our members perceive this to be an area that remains unsettled. We believe that it would be best for FSA to wait for the outcome on the scope discussion, as it relates to portfolio managers, before deciding its policy in relation to CIS and pension fund managers. We note also that work in CESR may impact on this area.

We query whether the FSA has any real understanding of who this proposed provision will impact and whether, in consequence, the proposal can be said to be proportionate. It is our understanding that, in the UK, a very substantial number of CIS managers outsource their investment management to their in-house asset management business or to a third party asset manager, with all the related execution business. Assuming that our understanding is correct – which we believe it to be, but cannot verify at this short notice with absolute certainty – then the FSA would be putting forward a complex and costly proposal to scoop up the transactions of a small number of small funds. It is incumbent on FSA to assess realistically the impact of its proposals, without which the FSA runs the risk of breaching the discharge of its general functions under FSMA, in particular with reference to section 2 (3) (a) and (c). We do not believe that the FSA has made a realistic assessment of its proposals. In addition, we suggest that the proposed course of action is likely to do nothing to further the FSA's desire to monitor transactions for purposes of detecting market abuse owing to the very limited number of transactions reports it is directed at.

An issue also arises in relation to the approach proposed by FSA, in which the MiFID requirements will be imposed on specified non-scope firms (managers of CIS and pension funds) and then the imposition will be alleviated by continuing with the current SUP17 exemption. The problem is that MiFID is not the same as the FSA's current regime. For example, under the current regime reporting to a Designated Investment Exchange would remove the need to transaction-report to FSA. But as MiFID does not carry forward the DIE regime, this would mean that applying MiFID and SUP17 to non-scope firms would leave such firms potentially exposed to having to make transaction reports in the future that they do not have to make now, in relation to trades on DIEs. Moreover, FSA is presumably content with its present regime and is indeed the author of the DIE regime. Why should it therefore seek to impose new and problematic requirements when it does not have to do so, other than in the name of some form of dubious equality?

In line with our response to CP06/14, we answer your question to say that we do not think you have provided sufficient Handbook guidance for CIS and pension fund managers to determine whether they should report transactions to FSA. Nor do we think that it is appropriate to provide guidance on issues of scope in the Transaction Reporting Users Pack, not least as the guidance in the Pack is expressed to be non-binding.

## **APPENDIX 1 - IDD AND MENU, POST MIFID IMPLEMENTATION**

The following is an extract of an email sent to the FA in June 2006:

Thank you for going through the thinking on the MiFID effect on the IDD and Menu.

Just to repeat, IMA has two overriding policy provisos:

- that we do not think that it is appropriate for collective investment schemes to be included within the "packaged product" regime; and that
- any change brought about by your review and MiFID should not create barriers to the marketing of CIS.

You explained, as I understood it, that your preferred option was to find a way in which to give FSA time to undertake a proper review of the disclosure needs, but that there was concern about the legal risk of non-implementation of MiFID in the interim period. I think that I too would prefer that option to attempting an Article 4 submission.

My suggestion was that the rules are changed wef 1 November 2007, to allow investment firms selling CIS to either use the current IDD and Menu, or to provide the MiFID-compliant information in some other format. The result, I imagine, would be that those selling insurance-linked products alongside investment funds will continue to use the IDD and Menu that would in any case be compulsory for the insurance-based products, while those dealing solely with investment funds (either stand-alone, as part of a service, or alongside direct equity holdings) can devise a method, style and timing of delivery that meets the requirements of MiFID. I anticipate that the financial adviser will continue to use the Menu because it is easier (no change), cheaper (no change) and less risky (moving from the prescribed format would introduce risk) to continue with the Menu, especially as this interim period is likely to be less than 12 months.

As we discussed, there is, in any case, little difference between the two sets of requirements, but the freedom may well produce some worthwhile alternatives for the FSA to consider. Specifically, in the case of UCITS, MiFID assumes the use of the Simplified Prospectus and that, additionally, information of any actual costs and payments received by the intermediary is passed to the customer.

From our point of view, firms dealing only in CIS would have the freedom to use a more appropriate delivery of the information than the current requirements allow, while no barriers are being placed on firms - i.e. they may continue to use the Menu - undertaking investment advice in both insurance-linked and investment funds.

I therefore believe that, from this proposal, the increased investor risk is minimal (if it exists at all - which I doubt), the legal risk is removed (use of any super-equivalent material would be voluntary), and the FSA gets its full time to consider the disclosure requirements in the light of the post implementation review of depolarisation.

## **APPENDIX 2 – THE PACKAGED PRODUCT REGIME**

### **Purpose of this paper**

The purpose of this paper is to discuss the impact of the implementation of MiFID on the information requirements provided to retail investors relating to collective investment schemes (CIS).

### **Summary**

We believe that the packaged product regime no longer provides the most appropriate framework for CIS, due in part from the changes in the distribution of CIS and the implementation of European Directives (UCITS and MiFID). The packaged product regime is no longer ‘fit for purpose’, as since its introduction a range of disclosure requirements have been introduced (Key Features and Simplified Prospectus for example), and other products have entered the retail sector (deposit-based products and SCARPs), neither of which fit comfortably with the original concept.

The FSA's Retail Distribution Review and the introduction of MiFID provide the FSA with an appropriate opportunity to undertake a fundamental review.

### **Impact of EU legislation**

The FSA has clearly stated that in implementing MiFID, they will only propose national measures that go beyond directive requirements when such measures are justified in their own right (including through the use of appropriate market failure analysis and cost-benefit analysis) and where they are consistent with directive provisions.

Similarly, the FSA has stated that implementation of MiFID would be used as an opportunity for radical review of existing Handbook material, removing measures that are no longer effective or proportionate.

There have, for some time, been EU requirements relating to information relating to UCITS as a product. These have been added to with the introduction, under UCITS III, of the simplified prospectus. Since units in collective undertakings are financial instruments caught by MiFID, that directive will, for the first time, introduce EU level requirements which also cover information relating to the intermediary or distributor who offers such products to investors. There is, therefore, a comprehensive EU regime for disclosure relating to investment funds.

The traditional UK approach in this area has differed from that of MiFID and most other EU countries, in that as a result of the “packaged product regime” rules for CISs have generally followed those designed and drawn up for insurance-based products rather than those designed and drawn up for securities, or specifically for CISs. This treatment is, as far as we are aware, unique as compared with other parts of the world where funds tend to be subject to their own regime or recognised as being more closely related to securities than to insurance products.

Any information regime for CISs will now need to be led by the requirements of MiFID and of the UCITS directive and not by existing UK requirements. While we accept that there may need to be alignment of disclosure requirements where similar products are offered in similar markets, we are concerned that the packaged product regime has led to a “one size fits all” approach in the UK. It has not allowed sensitivity to, for example, the nature of the relationship between advisers and customers, it has tended to mask product differences and it is straining to keep up with market developments.

We question, therefore, whether the “packaged product” regime can or should survive the implementation of MiFID.

## **History**

The “packaged product” regime has been in existence since the early days of the Financial Services Act 1986 and has been carried over through successive regulators, from LAUTRO and FIMBRA, to PIA and then to the FSA.

The basis of the regime is that for the purposes largely of marketing or financial promotion rules, life policies, units in regulated collective investment schemes (CISs), interests in investment trust savings schemes (ITSSs) and stakeholder pension schemes are put into the same category and treated in the same way.

Other particular problems that the packaged product regime was designed to address were the perceived conflict of interest created by the payment and receipt of commissions, and the disclosure of costs by the product provider.

In its origins, the main rule to which the regime applied was polarisation, but it has been continued in this depolarised world, presumably on the basis that these products operate in similar markets and similar distribution channels and should, therefore, be subject to the same rules.

## **Changes in the market**

The main characteristic of the packaged product regime is the disclosure requirement (in particular the key features document). This was devised at a time when with-profits insurance products were predominant in the savings market. There were very specific concerns about the charges investors faced, particularly in the early years and the lack of understanding about the effect of withdrawing from the investment before maturity. The existence of the regime led to the requirements designed to meet these concerns then being applied to investment funds, even though such funds have far flatter charging structures and do not include early withdrawal charges. It is evident that concerns remain about this aspect in areas other than investment funds, and criticism of this may also adversely affect the fund management industry.

The arrangements associated with the packaged product regime for providing relevant documentation to investors were also designed largely to fit with the distribution structures for insurance products. They were then applied to funds. This does not take account of the fact that regulated CISs and ITSSs are frequently used

in the wealth management world, as an alternative not to life products, but to direct equity investment.

The nature of the market is changing. While at the time of the introduction of the packaged product regime with-profits were the dominant retail product in the market, their market share has seriously reduced, largely in favour of investment funds.

At the time of the introduction of the regime, all relevant retail products were included, so there was a commonality of approach. Since then, the EU requirements laid down for the disclosure of CISs have breached that common approach in one way, while the introduction of new retail products, like SCARPs and deposit-based structured investments, that are not classified as packaged products, has resulted in the regime being inadequate.

While stakeholder pensions are within the regime, they have different rules applying to the provision of basic advice. It has also been proposed that the soon-to-be-regulated SIPPs enter the packaged product regime, which seems to be a step further still, in that the SIPP is a shell, a wrap, and may include other packaged products within it. Distribution structures are also changing.

Wraps and fund platforms of different types are becoming a major channel for distribution of investment funds (much less for insurance products), making the distribution channels for different types of packaged products less and less homogeneous. This rapid growth creates a need to ensure that the content and delivery mechanisms for information to investors are flexible enough to adapt to the different relationships which exist as between fund providers, intermediaries and clients.

Since the introduction of the packaged product regime, there has been a significant decrease in the proportion of funds sold direct to customers or through direct sales forces and the vast majority of funds are now sold through intermediaries, many of whom specialise in investment rather than insurance products, using funds as an efficient mechanism to achieve diversified exposure to a range of asset classes.

### **Issues arising from the regime**

The existence of a “catch all” regime which was primarily designed for insurance products has created a number of problems as it has been applied to funds. We believe that these are unhelpful to the investor, and may indeed be misleading.

#### *Disclosure of charges*

The mechanism for the disclosure of charges, for example, with the use of the reduction in yield (RIY) figures requires forward projections at an assumed growth rate. While it has been common practice for forward projections to be used in the insurance world, it has been avoided in the investment funds in order not to give a misleading impression about the potential behaviour of a fund (particularly in order to suggest any suggestion that there might be smooth growth within the fund) or to give

any suggestion to an investor that he could expect his fund to be worth a certain amount in future. It would be unthinkable that, in advising on direct equity investment, an adviser would give the impression that the share price might increase in a particular way, yet this is mandated for a fund investing in the same assets.

The application of the packaged product regime to funds has required firms to include projections and brought the UK out of line with most of the rest of the world (including US and EU) where the accepted indicator of charges (which is contained in the EU requirements for the simplified prospectus) is the Total Expense Ratio (TER). The misalignment of the two requirements has led to UK-domiciled funds marketed within the UK now having to show two figures, the RIY and the TER, which does not make for clear disclosure.

At the time of the introduction of the simplified prospectus, IMA pointed out the disadvantages of the RIY calculations, and of including both RIY and TER together. The growth of performance fees has highlighted this problem further, in that the RIY figures will not normally be able to incorporate such fees (when they are based on out performance of the market for example). This could be regarded as a significant inaccuracy in the information being provided to investors.

MiFID requires full disclosure of the costs of investing – through the simplified prospectus – and the costs of advice, so the investor is no less well-informed. The simplified prospectus clearly sets out the initial and annual charges and the annual operating expenses, including performance fees.

#### *Investor confusion*

We are also concerned about the existence of a regime which applies to a diverse range of different products with quite different characteristics and different protections provided to investors. There are, for example

- With-profits products which involve high charges for early redemption as compared to liquid investment funds which can be redeemed daily at net asset value; or
- insurance products which depend on the solvency of the insurance company as opposed to investment funds where the investor owns a beneficial interest in the assets of the fund and is protected by the existence of the depositary.

The different risk profiles of different products and the different risks to which investors are exposed, or protections to which they are subject have not necessarily been clear. The regime has also contributed to a tendency for problems in one part of the financial services sector tainting the reputation of others.

#### *Incompatibility with “modern” regulatory thinking*

We are also concerned that the use of a “catch-all”, such as the packaged products regime which has been inherited from past generations of regulators, may have been more appropriate in the more prescriptive regulatory environment in which they

operated. We believe that it no longer fits comfortably or logically in the context of principles based regulation, senior management responsibility and treating customers fairly.

### *The single market for funds in Europe*

The UK has been a strong supporter of attempts to improve cross-border activity in funds throughout Europe. Since many UK-based houses operate on a pan-European basis and find themselves frustrated by barriers to such business, it has been recognised that it is important for the UK to be seen as committed to enhancing competition, and in particular to allowing non-UK houses to operate as freely as possible within the UK.

Any consideration of UK requirements needs to take account of the impact these may have on funds established outside the UK which are marketed into the UK. In many cases (e.g. in the context of the simplified prospectus) the UK is unable to impose requirements beyond those of the home State, but even where it is possible it is important to recognise that this may act as a deterrent for non-UK funds being marketed into the UK. Where the FSA is not able to impose these additional requirements, it is possible that non-UK EU investment firms will be able to market its funds into the UK at a lower cost than can their UK competitors, so putting UK firms at a disadvantage.

In a market where funds from outside the UK are increasingly being offered to UK investors, it will be important to avoid investor confusion by having requirements imposed on UK funds which are substantially different from those imposed on funds from elsewhere in Europe.

### **The way forward**

In our view, the combination of MiFID and the UCITS directive provide a very clear and sufficient approach in relation to information provided to retail investors for these instruments: the UCITS directive contains requirements on product information, in particular the simplified prospectus, which are then recognised in MiFID as providing appropriate information about the financial instrument and the costs and charges relating to the UCITS.

We believe that, given that they operate in the same market, the same rules should apply to non-UCITS retail funds (NURSEs)

We acknowledge that there has been criticism of the simplified prospectus (not least by ourselves) but this criticism has been recognised, both by the Commission and by the Expert Group set up to advise the Commission on improving the efficiencies in the European market for funds, and the contents are being actively discussed. We believe, therefore, that the FSA's approach should not be to seek to remedy the position through imposing different requirements on a unilateral basis, but through continuing the active engagement in the discussion at European level.

MiFID also imposes information requirements in relation to the services provided by an intermediary – including, for example, information about charges which are not related to the funds, but to the services and remuneration of the intermediary. Such requirements apply to all MiFID instruments and we believe that there is no reason why there should be a differentiation of approach as between, for example, advising on direct investment in equities or advising on investment in equities through a fund: in both cases there are clear disclosure obligations on the intermediary, as well as the requirements to act honestly, fairly and professionally in accordance with the best interests of clients, rules on conflicts of interest, suitability and appropriateness, etc.

The mechanisms associated with the packaged product regime were designed to fit a distribution mechanism used for life products but is cumbersome where funds are an alternative to direct equity investment and do not take account of the rapid development of wrap platforms and supermarkets.

We note with regret the FSA's recent decision to extend the IDD/Menu requirements past the date of implementation of MiFID, thus becoming super-equivalent, and not to adopt the alternatives. We had proposed a solution that would have met the FSA's declared wish not to be super-equivalent with the wish not to impose additional costs, while still providing flexibility and appropriate investor protection.

### **Benefits for Consumers**

The packaged product regime has become something of an illusion. Investors do not receive information that is directly equivalent. We would argue that the costs to the investor are more transparent in a CIS than they are in other packaged products, or in other retail products. The EU-based regime provides for the disclosure of all relevant information, but allows for it to be disclosed in a manner and style that is appropriate to the circumstances.

This is in the interests of consumers. We believe that changes should be made to the simplified prospectus to make it more consumer-friendly. The most desirable outcome for investors – and for investment firms and regulators – is that they understand the most important details of the product in which they are investing, such that the chance of them investing in the wrong product is minimised. The range of retail products mean that requiring a single approach, a one-size fits all approach, may well result in the specific costs and risks of the product not being identifiable. Having full disclosure of all relevant information displayed in a manner appropriate to the type of product being offered is more likely to achieve that end.

### **Conclusion**

Our conclusion is that the European regime provides a comprehensive approach to information requirements about funds for retail investors. Attempts to continue to apply the existing packaged product regime would not fit comfortably with these requirements; they would cause divergence as between the UK and other Member States and would involve going beyond the EU requirements. We do not believe that a case for doing this has been made.

We accept that in some (but by no means all) circumstances, funds are distributed in a similar way, and are seen as an alternative, to insurance and banking products, and there is then a justification for alignment of relevant aspects of disclosure. In this case, the EU requirements for funds need to provide the benchmark and starting point, with sufficient flexibility for the differences in the products and protections for investors to be properly communicated.

The introduction of MiFID clarifies that the marketing of funds will be subject to Home State regulations. The additional requirements currently imposed through the packaged product regime act as a disadvantage to UK-domiciled firms, both in marketing cross-border, and in competing in the UK with investment firms domiciled elsewhere in the EU.

In June the FSA announced the establishment of a retail distribution review, and we now note that the scope and shape of that review is due to be published in November. We believe that this provides an appropriate opportunity for the FSA to initiate a fundamental review of the packaged product regime, and that any replacement should be more aligned with the market. Investors are different now from when it was introduced, as are the products available and the routes by which they are distributed.