

Association of British Insurers response to CESR's Draft Technical Advice on Possible Implementing Measures of the Directive 2004/39/EC on Markets in Financial Instruments: 2nd Set of Mandates

Introduction

The Association of British Insurers (ABI) represents the collective interests of the UK's insurance industry. The ABI has around 400 companies in membership. Between them, they provide over 97% of insurance business in the UK. In the course of their business ABI members provide protection, pension and savings products to millions of policyholders and savers at the retail level or through institutional frameworks and, as a result of these business streams, manage assets of the order of £1,100bn (€1,600bn) through internal departments, fund management subsidiaries or third parties.

Although ABI members as insurance companies are not directly covered by the Markets in Financial Instrument Directive (MiFID), many of them have subsidiary firms that will be covered by the Directive. The collective investment fund industry in the UK is worth around £250 billion. ABI members account for around half of this. The potential impact of MiFID on the operation of financial markets could be of important consequence to ABI members and their clients. Insurers are also concerned that firms of advisers who offer insurance products under the Insurance Mediation Directive as well as investment products under MiFID should not face inconsistent regulatory requirements.

We have responded below to questions and aspects of the draft advice that are of interest to ABI members. But in summary the key points we wish to make to CESR are:

- The definition of investment advice should relate to specific financial instruments and should not be extended to incorporate generic advice;
- The suitability test should be linked to the level of risk involved in the financial transaction;
- No Level 2 measures should be adopted on 'at the initiative of the client' in defining the scope of execution only sales.

Implementation of MiFID

The ABI notes this consultation is one of a number of overlapping consultations that CESR has issued in recent months on MiFID. It is important for the industry (and other interested parties) to have the opportunity to input as draft advice is developed. However, we are somewhat concerned by the volume of important issues arising from these consultations. Meanwhile, the UK Government is currently planning to consult on implementation of MiFID before the European Commission has finalised the Level 2 regulations, because the MiFID implementation deadline of April 2006 is approaching. Therefore, we echo the views of other trade associations in the UK and across Europe that the Commission should delay implementation of MiFID. This would provide the necessary time for CESR to conduct consultations and for the industry to put in place the system changes required by the final rules.

We are also concerned by the absence of a cost-benefit analysis in this consultation, and urge the Commission to include one when it consults in future on proposed Level 2 advice.

Definition of 'investment advice'

Q1.1. – Do you agree that advice on services, such as recommendations to use a particular broker, fund manager or custodian, should not be covered?

The ABI agrees with CESR that advice on services should not be covered. The Level 1 text is clear that 'investment advice' is provision of recommendations on transactions relating to financial instruments, rather than recommendations to use particular services. If a consumer is advised to use an investment service, and this leads to subsequent advice to purchase a financial instrument, the service itself will be regulated. So a definition that also incorporated advice on services would be disproportionate, particularly given that no Member States currently regulate advice on the provision of investment services. Care needs to be taken, however, to ensure that the rules do not leave room for advice on services which is effectively advice on a particular product.

Q1.2. – Do you agree with the approach that a personal recommendation has to be held out as being suited to, or based on a consideration of, the client's personal situation or do you consider this criterion to be unnecessary or ambiguous and would like to refer to the bilateral nature of the relationships and bilateral contacts between the firm and its clients? In the latter case which criteria would you use to differentiate between a 'personal recommendation' and a 'general recommendation' or a 'marketing communication'?

We agree that personal recommendations should be based on consideration of the client's personal situation, rather than on all forms of bilateral communication between an investment firm and the client. An excessively broad definition of a personal recommendation may inhibit general communications between the firm and consumers, where no advice is offered and recommendations are not based on the particular circumstances of the client. It would be detrimental to consumers if firms could not continue to provide such information.

We recommend that the definition of personal recommendation should exclude the reference to 'implicit' recommendations (Box 1 para 1). Information – such as direct mail – is sometimes provided on financial instruments on a non-advisory basis, and this may inadvertently be defined as an implicit recommendation.

Q1.3. – Do you think it is reasonable to restrict 'investment advice' to recommendations of specific financial instruments or is it necessary to cover generic information including financial planning and asset allocation services for financial instruments?

The ABI strongly urges CESR not to extend the definition of 'investment advice' to include 'generic advice'. The Level 1 wording states 'investment advice' relates to transactions rather than more general financial planning. If asset allocation advice

leads to a subsequent transaction, then any advice provided on it will be a personal recommendation and therefore covered by the Directive.

Where it does not relate to particular financial instruments, it will be difficult to define 'generic advice' for regulatory purposes without unintended and undesirable consequences. For example, the ABI is actively supporting FSA activities to expand the provision of generic advice services. Generic advice services help consumers to understand and prioritise their financial needs, and they are not currently regulated in the UK. Wider access to generic advice is a central component of the FSA's financial capability initiative, which aims to increase the financial literacy of UK consumers. The UK Government included promoting public understanding of the financial system as one of the FSA's statutory objectives. If the definition of investment advice incorporates financial planning services, the FSA will be required to extend its regulatory regime. The extension of regulation to cover generic advice will add to the costs and deter provision of generic advice, potentially denying consumers access to a service from which they might benefit. We do not think this was the intention when the Directive was negotiated. So we recommend that CESR advises the Commission to define investment advice in relation to specific recommendations on financial instruments.

General obligations to clients

3.1 Do you agree with the proposals on portfolio management? Should any other issues be addressed under Article 19(1)?

The ABI welcomes the inclusion in the Directive of a general obligation on providers of investment services to 'act honestly, fairly and professionally in accordance with the best interests of its client'. This is consistent with the domestic requirements on all ABI members (as regulated by the FSA) to treat their customers fairly. However, we do not think the proposed Level 2 advice – with general references to defining investment strategies and management objectives – is particularly relevant and therefore we propose that it should be removed.

Suitability Test

The ABI broadly welcomes the approach taken by CESR to the draft Level 2 advice on the suitability test (Article 19(4)), though we recommend some drafting changes.

Given that the mandate from the Commission asks CESR to 'define the criteria for assessing the minimum level of information', we agree with CESR that it would not be appropriate to advise on the specific types of information that investment firms should obtain from clients. However, we note that the draft advice does specify particular types of information that might be obtained by the adviser (Box 8 para 1), so we recommend this should be redrafted. Different requirements should be applied on the basis of the risks associated with different financial instruments. The draft advice is correct to state, 'The nature and extent of the service provided to the client and the risks involved in the envisaged transactions will be relevant in determining the nature and extent of information that is necessary regarding the client's financial situation' (Box 8 para 2) a) ii)).

We are also pleased that the proposed advice on the criteria for assessing suitability states, 'The greater the level of risk involved in the envisaged transaction the more important the financial situation of the client or potential client will be in determining suitability' (Box 8 para 6 c)). We urge CESR to include this criteria in the final advice it submits to the Commission.

The UK Government is introducing a suite of regulated 'stakeholder' products with price caps and risk controls. This includes a medium-term investment product, which can be a collective investment scheme (and will therefore be covered by MiFID) or a unit-linked life product. For the sale of stakeholder products, the FSA has developed a new form of advice ('basic advice') with less onerous information requirements and a more limited form of suitability test than applies to advice on other more risky investment products. The ABI supports this approach, as it has the potential to reduce the regulatory costs of distribution. It could lead to consumers who are currently excluded from the market having access to simple investment products. We therefore consider that it is in the consumer interest for the CESR advice to allow regulators to vary their information and suitability requirements to reflect the risk profile of the financial instrument.

We are concerned that the entitlement of investment firms to rely on the information provided by a client is qualified by the statement 'unless it is manifestly inaccurate or incomplete' (Box 8 para 4). We do not think a firm should be expected to establish the accuracy of information which a customer provides in the course of advice. We think the equivalent wording should also be modified in relation to the appropriateness test (Box 9, para 4).

The ABI believes the proposed requirements on firms to keep their client profile under review (Box 8 para 5)) are potentially onerous and costly for firms and consumers. Advice is offered on the basis of information provided by customers on their circumstances at the time, so there should be no requirement to continuously keep this information under review. Some customers may be reluctant to be expected to disclose changes in their circumstances to their adviser. Nor do we consider it feasible to expect large organisations, providing many different types of financial services, to take account right across the firm of any development they become aware of that changes the situation previously described by the client. We suggest that this paragraph should be removed from the draft advice.

Appropriateness test

The ABI considers that the draft advice on the criteria for assessing the minimum level of information that should be obtained from a client, and the appropriateness for the client of a product is overly prescriptive. It is clear that the intent of the Directive is that the appropriateness test (Article 19(5)) requirements on firms providing non-advisory services should be less prescriptive than the suitability test requirements that apply to advice. The references to collecting 'information on the types of services, transactions and products the client is familiar with and his trading history' and 'defining appropriate investment parameters' does not properly reflect this intent. The draft advice should be proportionate, particularly if some direct offer services do not qualify for the definition of execution only and must comply with the appropriateness test requirements.

The ABI agrees that there is no need for CESR to add to the Level 1 text in relation to the content of warning for clients regarding investment products.

Execution only

Q5.1. In determining criteria, should CESR pay more attention to the legal categorisation or the economic effect of the financial instrument?

The criteria for determining 'other non-complex' financial instruments that can be sold on an execution only basis (Article 19(6)) should be the economic effect. The risks in terms of potential outcomes for the client are the key regulatory issue rather than the legal categorisation and design of the instrument. However, if CESR does opt for legal categorization, it should add that financial instruments which have a standardised design (whether provided by industry initiative or government regulation) should be regarded as non-complex financial instruments.

Q5.2. Do you think that it is reasonable to assume that a service is not provided 'at the initiative of the client' if undue influence by or on behalf of the investment firm impairs the client's or the potential client's freedom of choice or is likely to significantly limit the client's or potential client's ability to make an informed decision? Alternatively, do you think that the consideration of this overarching principle is not necessary because the use of undue influence could be subject to the general regulation under the UCPD and that CESR should base its advice more strictly on Recital 30 or refer entirely to this Recital advising the Commission that it is not necessary to adopt Level 2 measures in this area?

The ABI does not think it is necessary for CESR to advise the Commission to adopt Level 2 measures on 'at the initiative of the client'. We agree with the assumption in Recital 30 that the investment service has been provided at the initiative of the client, unless the stated specific circumstances are met. We have concerns about the vagueness of the language in the draft advice used to define when the service is provided at the initiative of the client. It would be excessively restrictive to regard general personalised communications on financial instruments as 'undue influence'.

If CESR advice is provided, it should make clear that a communication is not a personalised communication merely because it is addressed to an individual and targeted at a particular group of customers. This is necessary simply to ensure that it reaches the potential customer through the post or by email, but the information will not be specific to the circumstances of the individual, and therefore a subsequent purchase could be execution only.

Markets

As users of financial markets ABI members have welcomed the technical developments of recent years which have allowed the creation of new execution venues. They believe the competition introduced as a result of the operation of MTFs and internalisation has been to the benefit of their ultimate clients.

From our discussions with counterparties representing providers of execution venues we are aware of concerns that: -

- the definition of systematic internaliser at Level 2 is more widely drawn than was intended at Level 1 and
- that the pre-trading transparency obligations are at risk of being widely drawn for such organisation with consequent cost implications

Whilst technically whatever system finally prescribed could be made to work the higher risk taken on by the internaliser for a quasi market making role would need to be priced in. In addition the increased operational resources to provide quotations would have to be added to the costs of any necessary systems changes. Should these fears be borne out then as well as the increased cost base reflected in charges to clients, the prospect arises that systematic internalisers may reduce or withdraw from this activity.

The resultant potential impact on the broader market through a reduction in competition between execution venues might lead to higher costs for institutional investors such as ABI members (representing millions of savers) wherever they placed their dealing for the largely theoretical benefits in terms of market efficiency and investor protection that the Level 1 and Level 2 proposals in these areas sought to achieve.

The ABI would urge CESR to adopt a cautious approach possibly with a phased approach to market changes but with sufficient clarity so that systematic internalisers and other market participants benefit from certainty in the medium term.