The retail distribution review: retail financial services; regulation; financial advice market review

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Published in:
Journal of Financial Regulation and Compliance

DOI:
10.1108/JFRC-08-2015-0044

Publication date:
2016

Document Version
Early version, also known as pre-print

Citation for published version (Harvard):
Ring, P 2016, 'The retail distribution review: retail financial services; regulation; financial advice market review', *Journal of Financial Regulation and Compliance*, vol. 24, no. 2, pp. 140-153. https://doi.org/10.1108/JFRC-08-2015-0044

The Retail Distribution Review: problems, responsibilities and regulation

Introduction and Aim

Context

> … the Retail Distribution Review (RDR) is one of the core strands of our retail market strategy ……. It is essential for promoting a resilient, effective and attractive retail investment market. The RDR will modernise the industry, giving more consumers confidence and trust in the market at a time when they need more help and advice with their retirement and savings planning. (FSA, 2008a:3)

The Retail Distribution Review (RDR), which came fully into effect at the beginning of 2013, is the most recent in a series of regulatory reforms in the UK retail advice sector. Its stated aim is to create a competitive advice market which provides clarity and innovation in relation to retail financial products and services, along with adviser professionalism that inspires trust and enables consumers to have their needs addressed (FSA, 2009a:5).

Many would argue this was not a moment too soon. A line of scandals, including endowment mortgages, personal pensions and split capital bonds (Black, 2002; Dunn, 2009; Goff and Cadman, 2014), suggested previous reforms had limited effect on the advice market and consumer outcomes. As the Financial Services Authority (FSA) itself put it in 2007:

> there are features associated with the distribution of retail investment products that result in inefficiencies for the market and poor outcomes for consumers. This is despite intensive regulation in this area for nearly two decades. (FSA, 2007:12)

The RDR changes take effect at an important juncture in UK retail financial services. The automatic enrolment of individuals into pension arrangements, as well as the introduction of pension 'freedoms', respectively 'nudge' (Thaler and Sunstein, 2008) and entice individuals into having to make more, and more complicated, financial decisions. Such decisions involve the management of financial risk to ensure secure long-term outcomes. As a consequence, the issue of the availability of quality advice takes on greater significance.

Previous reforms

> "A principal aim of regulation is to deal with market failures. These have manifested themselves in various ways in the distribution of retail investment products. We are using this review to address these issues…." (FSA, 2007:15)

Market failure is a driver of the RDR, but was also the motivation behind previous significant reforms in the retail advice market. In 2004, the FSA attempted to increase choice and competition on the supply side by introducing the concept of a 'multi-tied' adviser, who could advise on the products of a number of provider companies (up until then advisers had to advise on the whole market, or advise on just one provider's products). The intention was to increase the product choice available to consumers. (FSA, 2002a; FSA, 2003). On the demand side, reforms included increased disclosure of information, particularly about product charges. Here, the regulator argued that

> "We expect the initial disclosure information to influence consumers' own decisions — before taking financial advice — about whether the services being offered are right for them. This in turn may empower customers (in that it would give them an idea of what to expect) and encourage 'shopping around' — neither of which is common in the current retail financial services market." (FSA, 2003, Appendix D: 27)

Yet, by 2007 it had become clear that attempts to improve the supply side had created a lack of *clarity* for consumers about the status of advisers and the nature of the advice on offer. The FSA then indicated it needed to "improve the clarity for consumers of the characteristics of different service types and the distinctions between them" (FSA, 2008a:3). At the same time, it recognised the *cost* of advice meant that, in some cases, those who could afford to save could not afford the advice to enable them to make appropriate savings decisions (FSA, 2007). Payment for advice using commission was coming under increasing criticism. It was also clear that many *consumers* no longer felt able to trust the financial advice sector (FSA, 2008b; Ring, 2012)

Aim of article

This article therefore critically examines the potential of the RDR to create the kind of advice market envisaged by the regulator. This takes on particular important in the light of the recent announcement that government is again reviewing the regulatory framework of the financial advice market (HM Treasury, 2015). The analysis focuses on three key issues: clarity, cost and consumers. It argues that whilst the RDR has proved to be relatively successful in some regards it have also run up against difficulties, as did the de-polarisation reforms before it.

The discussion begins by examining the rationale for the reforms, before going on to consider RDR in the context of clarity, cost and consumer outcomes. First, it examines the notion of 'advice', arguing that the RDR has created confusion in what is already a complex financial market. Second, it examines reforms of the method of payment for advice, suggesting that whilst they have some benefits, they have also created challenges for consumers seeking advice. Finally, it examines the attitudes and behaviour of financial consumers and suggests that this creates range of problems and difficulties in this new advice landscape.

RDR Reforms

Following upon 18 Consultation Papers, 5 Discussion Papers, 15 Policy Statements and 17 separate pieces of research, the implementation of reforms constituting the RDR was completed on 31st December, 2012 (FSA, 2015). The reforms have three main strands. The first concerns advisers and the service they provide. Under the RDR, advisers must either be 'independent', taken to mean providing unbiased, unrestricted advice based on a comprehensive and fair analysis of the relevant market; or be restricted, a term capturing the provision of any advice which is not independent. The nature of the service being provided must be disclosed to the client in writing. The aim is to provide greater clarity for customers (FSA, 2009a).

Second, the payment of product provider commission to advisers recommending provider products to clients is now prohibited. Instead, advisers can only be remunerated by 'adviser charges', agreed with the client at the start of the advice process. The intention is to avoid any potential of commission bias influencing adviser recommendations (FSA, 2009a:23). Third, advisers must pass exams at a level equivalent to the first year of a University degree before they can provide advice, in order to "deliver standards of professionalism that inspire consumer confidence and build trust" (FSA, 2009a:40). Thereafter, they must meet annual CPD requirements as well as following a Code of Ethics.

It was argued these reforms would "deliver more clarity" in relation to products and services, establish "remuneration arrangements that allow competitive forces to work in favour of consumers", and create an advice market where consumers can "have their needs and wants addressed" (FSA, 2007:17). The removal of commission is regarded as important for increasing consumer perceptions of professionalism and trust. At the same time, the regulator believes that transparency in the cost of advice can enable consumers to exert more influence in the financial advice marketplace (FSA, 2007).

We now turn to examine these reforms in the context of the three issues already identified: clarity, cost and consumers.

Delivering Clarity - From intention to reality

Under the Financial Conduct Authority's (FCA) Regulated Activities order, for advice to be regulated it must be given to a person or their agent, concern a specific investment, and relate to whether that investment should be made or not. If the 'advice' does not have all of these characteristics, then it is not 'regulated' advice but 'generic' advice, and not a concern of the regulator. For example, advice to buy shares in the oil sector or in a particular country would be generic advice as it does not relate to a specific investment. It would not be covered by the FCA's regulatory protections. In the retail sector, however, advice will normally include a personal recommendation of a specific investment, and so be regarded as regulated advice.

As part of the RDR's consultation, the regulator had initially proposed a simple distinction between advice and sales with 'advice' being regarded as advice across the whole of the market on a fee only basis i.e. 'independent' advice. However, given the terms of existing European legislation, and the effect it was argued such a change would have on the marketplace, the proposal was considered unfeasible (FSA, 2008a). This eventually led to the creation of a distinction between 'independent' advice and 'restricted' advice.

Regulatory requirements mean that a recommendation for retail investment products must be 'suitable'; that is, it must take account of the personal circumstances of the client. Independent advice is distinguished by defining 'suitability' to mean that independent advice must be based on a comprehensive and fair analysis of the relevant market which is unbiased and unrestricted. The 'relevant market' comprises all retail investment products which are capable of meeting the investment needs and objectives of a client. That requires an advisor look at the whole market of possible retail investment products, although in practice it is possible for an advisor to provide less comprehensive advice where she comes to the conclusion that the client's needs can only be met by a limited market, or where she holds herself out as being 'independent' but only in relation to a (limited) 'relevant market'. In sum, it is possible for 'independent' advice to have restrictions. A firm must indicate where independent advice is being provided in relation to a limited market.

As regards the regulator's rule book definition of 'restricted advice', it is defined as advice which is neither independent advice nor basic advice (basic advice is simplified advice relating only to stakeholder pension arrangements). There is no further regulatory definition of restricted advice, although the regulator has indicated that, as regards suitability, restricted advice can be limited both in relation to its focus (e.g. relating only to specific identifiable needs of clients) as well to the range of product providers in relation to which that advice is provided (FSA, 2008a).

In discussing restricted advice, the FCA also refers to firms offering 'limited' or 'focused' advice; terms which it appears to use interchangeably, but neither of which are defined regulatory terms. In either case, it is referring to advice focused on a specific need of the customer that does not require the adviser to take account of the full personal circumstances of the client in considering the suitability of the product. Given the limitations that can apply to independent advice, the regulator has acknowledged that it is possible focused/limited advice could meet the definition of independent *or* restricted advice (FSA, 2012). To perhaps complicate matters further, it is also possible for a single adviser firm to offer both independent and restricted advisory services.

The regulator has also been keen for the industry to offer some form of less costly advice falling short of the requirements of independent and restricted advice: "This concept could be likened to an off-the-peg suit as opposed to a bespoke suit." (FSA, 2007:60). It has therefore issued guidance on what it refers to as 'simplified' advice (FSA, 2012), although again this is not a term defined in the regulator's rulebook. It notes that this "has some similar characteristics to 'focused advice'" (FSA, 2012:2), and might be characterised as restricted advice that involves streamlined (generally assumed to be automated) processes.

Ironically, in a drive for greater clarity, it now appears we have an advice landscape that, as far as the regulator is concerned, includes regulated, independent, restricted, focused, simplified, basic and generic advice. It might be said there is a 'continuum' of advice which, based on past experience (Ring, 2004), could lead to consumer confusion and provide ample scope for dubiety and for consumers to be misled. Research undertaken for the FCA in 2013 indicated significant confusion between independent and restricted advice amongst consumers (NMG Consulting, 2013). Whilst disclosure of these terms by firms to clients in conformity with regulatory requirements may have improved in recent times (FCA, 2014a and 2014b), "consumer research indicates that differences between independent and restricted advice are still complex and confusing for consumers" (Europe Economics, 2014:33).

It is worth noting here that one piece of research (NMG Consulting, 2014b) conducted for the FCA indicates that the majority of consumers were clear whether they were receiving regulated financial advice or not. However, this was when they were told before answering the question that it meant what they had received 'is a tailored recommendation from a qualified individual given after due consideration of your personal circumstances and objectives, so they recommend products or give you advice that is suitable only for you'. They may have been clear they did not receive this specific service; however, as the Financial Services Consumer Panel (Advice Gap, 2012) has noted, consumers interpret the word "advice" in a much broader and more elastic way which can introduce dubiety and confusion. For example, there is evidence indicating many consumers believe all regulated financial advice is independent (NMG Consulting, 2014a). The potential for confusion is neatly illustrated by the FCA itself:

> "Firms should be mindful that if a recommendation is put forward in such a way that a reasonable observer would view it as being based on a consideration of a customer's circumstances or presented as suitable, then this is likely to amount to a personal recommendation. However, while the customer's own perception of the service received is very important, it is feasible that the customer will not always be correct in their understanding." (FCA, 2014c:41)

Importantly, none of this is taking place in a vacuum. Government has been keen to encourage financial 'guidance', something that falls short of regulated advice (FCA, 2014c). Unfortunately, the clarity of the difference between the two is debatable (Hamilton, 2014). In addition, the UK's main provider of financial guidance refers to its 'own free and impartial *advice* service' (the Money Advice Service, 2014) and the organisations delivering the Government's new Pensions Wise pension information service are The Pensions *Advisory* Service and the Citizens *Advice* Bureau (Cumbo, 2014). It is perhaps no surprise that the ABI has sought clarity on the distinction between full advice and the provision of information (Norman, 2015a).

Cost

An important element of the RDR reforms was the requirement that advisers can no longer be paid for the advice they provide to their customer through commission from a product provider. Instead clients pay adviser charges, agreed with the adviser at the start of the advice process. The ban includes ongoing annual commission, previously often a means of stretching the payment of commission by the product provider over a longer period (in contrast to a 'one off' payment). Now, ongoing payments must also be agreed between the client and their adviser, and tied to the provision of a specific ongoing service for those payments.

This reform has two key objectives. Firstly, "to reduce the potential for remuneration to influence adviser recommendations, directly or indirectly" (FSA, 2009a:23). Secondly, the regulator's intention is to increase competition. If the cost of the advice is not 'hidden' in the cost of the product, the cost of both the advice and the product is clearer to the customer (FSA, 2008a). There is no doubt that the move to fee based remuneration, alongside the RDR's focus on professionalism, is a positive step in attempting to enhance the image of the advice sector and increase the transparency and trust that should be the essence of the advice relationship (see NMG Consulting, 2014b) but which has suffered in the wake of various scandals.

That said, there are a number of difficulties that remain. For example, if disclosing the cost of advice is meant to enhance competition, it should be noted that even before the RDR reforms, the cost of the commission, in monetary terms, had to be made clear to the client. Yet awareness of the relevance of this figure was traditionally poor (FSA, 2004). In any event, both previous and more recent consumer research suggests price is not the major factor when consumers choose an adviser (FSA, 2002b; NMG Consulting, 2014b). Recent research in relation to ongoing charges also found that nearly half of those surveyed did not know they were actually paying for ongoing financial advice; and even a majority of those who did know were not aware of how much they were paying (NMG Consulting, 2014c). As research conducted for the regulator notes, all of this "suggests that switching or shopping around among consumers would not increase significantly, even in the event of full compliance with transparency and disclosure requirements" (Europe Economics, 2014:34).

Of course, all this assumes that charges are being properly and adequately disclosed. A Thematic review by the FCA in 2014 found half of firms reviewed failed to meet regulatory requirements to give clients clear upfront generic information on how much their advice might cost, as well as failing to give clear information to clients as to what advice would cost them as individuals (FCA, 2014a). Just as worryingly, whilst the 'unbundling' of charges as between product providers and advisers is a step towards greater transparency in relation to overall costs, there is still much work to be done to separate out the various different costs within the investment value chain. Evidence suggests "that many investment managers are themselves unaware of the costs ….. to which they are committing client money" (Pitt-Watson et al., 2014:7). Aside from the cost of advice, the other costs of incurred as a result of an adviser's recommendation are far from clear (FSCP, 2014).

The move to fee-based advice has also led advisers to look at their business models (Clare et al. 2013; Hines and Siddle, 2013; JP Morgan Asset Management, 2012). The RDR has increased the cost of advice and, in conjunction with the removal of commission, has reduced the opportunities for client cross-subsidy (BDO 2012: Clare et al, 2013; Fundscape, 2014). This has brought about a 're-alignment' of the provision of advice. There is evidence that the reforms have taken the cost of advice out of the reach of many consumers; more properly put, it has either put off many consumers from taking advice or made them unprofitable for financial advisers (Deloitte 2012 and 2013). It has been suggested that clients need somewhere between £61,000 and £100,000 of investible assets to be profitable for an adviser, although it is estimated around 75% of the population do not own over £60,000 of assets. (Clare et al, 2013; Fundscape, 2014) It is no surprise, then, that nearly half of advisers polled in one survey considered the 'mass' advice market to be 'unattractive', and 25% 'very unattractive' (Clare et al., 2013:10); that advisers are segmenting their customer base, generally focusing on high net worth clients (Europe Economics, 2014; Fundscape, 2014); and that banks are moving out of the mass advice market (Fundscape, 2014).

At the same time, many consumers have expressed a general unwillingness to pay 'up front' fees, with a survey by Deloitte (2012) indicating that around one third of investors would cease using advisers if charged directly. The figures were more stark in a subsequent survey, which also found half of those willing to pay a fee were unwilling to pay more than £50 per hour, when the average fee was estimated to be £165 per hour (Clare, 2013). More recently, one survey found retirees indicating they would be prepared to pay, on average, a total of £253 for advice (Holt, 2015). By contrast, other research (CII, 2013; NMG Consulting, 2014b) has indicated that the cost of advice may not be the *main* reason for individuals not seeking advice, although it does not indicate the extent it might nevertheless be a contributing factor.

One final point to note on cost is the prevalence of fee charging on the basis of a percentage of the funds invested (Europe Economics, 2014). To the extent that advisers are providing an ongoing service – usually an annual review – one wonders about the degree to which the amount of time, effort and cost expended annually on the client (even taking into account the costs of professional indemnity) are accurately reflected by a level percentage of a (generally increasing) fund. That said, given the level of client awareness of ongoing costs discussed above, advisers are unlikely to be challenged on this any time soon.

The Consumer

As already indicated, a key objective of the regulator in implementing the RDR was to create a "market which allows more consumers to have their needs and wants addressed" (FSA, 2008:5). Ironically, it is argued by some that the trends already identified above concerning the cost of advice, unwillingness to pay a fee up front, and the re-alignment of adviser business models, has reulted in an 'advice gap' (Fundscape, 2014). The estimates concerning the number of people who would 'fall out' of the advice market post-RDR (Deloitte, 2012; Fundscape, 2014) or be unwilling to take advice (Clare, 2013) differ, but they all amount to millions of consumers, and potentially a majority of those who have taken advice in the past (Deloitte, 2012). Whilst such estimates have been questioned (Europe Economics, 2014; NMG Consulting, 2014b), there is certainly considerable debate about the affordability of advice post-RDR, and the extent to which independent and restricted advice models can broaden their current appeal and scope. Whatever the true extent of these issues, the Treasury appears to accept that there is an advice gap for those who do not have 'significant wealth' (HM Treasury, 2015), and the fact remains that millions of financial services consumers are not taking financial advice, with a rise in the so-called 'DIY' investor (Fundscape, 2014).

Contrastingly, it has been argued that these trends point to a 'guidance gap', and not an 'advice gap'. It is argued individuals need "resources that will provide them with all of the information that they would need to make investment and savings decisions on their own" (Care, 2013:7). It is envisaged that these are people who "will be without professional financial advice in the post-RDR world and that will not have the confidence to make their own decisions in the absence of professional advice but who, nevertheless, will be in need of financial guidance in order to maintain the health of their personal finances" (Clare, 2013:7)

It could certainly be argued that the creation of the Money Advice Service and the roll-out of Pension Guidance in the wake of the government's recent 'pension freedoms' are an acknowledgement of the importance of 'guidance' in the new post-RDR landscape. In fact, an increasing amount of 'guidance' for financial consumers is being provided by financial services firms direct to customers through web-based platforms or direct from providers, with the former increasing by as much as 29% in 2012 and 41% in 2013 (Rice, 2013; Fundscape, 2014). The increasing ubiquity of consumers researching and transacting online, and the ease of access to online services, means that transactions online have become a significant means of undertaking non-advised investments. This is reflected in the increase in the use of direct to customer offerings which may provide information, projections and model portfolios, but which do not offer regulated advice. The use of devices such as filtered fund lists, pre-presented portfolios with indicated levels of risk, and default funds can help make decisions easier for consumers by making use of common behavioural biases. That said, they can incorporate such biases in ways that may not always work in the best interests of the consumer. For example, recent research has shown how consumers in the non-advised sector appear to take more risk than is consistent with their risk tolerance (NMG Consulting, 2014b:32).

Research into the non-advised sector also found that the majority of the sample examined were making 'broadly appropriate decisions', although a significant minority were making mistakes such as investing in high risk products without being aware of the risk profile, holding a product different to the one they thought they had bought, or not being tax efficient. Whilst the majority of non-advised in the same research indicated they were confident about making the right decision (NMG Consulting, 2014b), this has to be understood in the context of over-confidence being a common behavioural bias (Dunning and Kruger, 1999; Dixon, 2006). General levels of numeracy and literacy would also tend to support the position that confidence is not the same as capability (Department for Business, Innovation and Skills, 2013). In the context of the rise of the DIY investor and her use of internet guidance, it is only a short step to argue that, at least to some extent, consumer decisions are relying upon the expert rationale underlying the algorithms and logic which drive the various tools, illustrations and guides provided by 'non-advisory' sources. This has led some to claim such developments are "blurring" the concepts of investment guidance and investment advice (Merret, 2013).

In the meantime, since 2007 the regulator itself has attempted to encourage advisers, with little success, to increase the provision of 'simplified advice' – more streamlined processes enabling advice to be delivered in a more cost-efficient (and therefore cheaper) manner in limited and less complex advisory situations. Although the intention is to address any gap arising from lack of demand for 'full' RDR-compliant financial advice, the regulator maintains the same charging, disclosure of status and professionalism requirements must apply to any 'simplified' approach. Despite the regulator twice attempting to spell out the specific nature of simplified advice (FSA, 2012; FCA 2014c), there has been continuing criticism over the financial viability of this model and the potential liabilities advisers believe it may lay them open to with the Financial Ombudsman Service (Norman, 2015a). The regulator has nevertheless now indicated it is willing to work with individual firms through its new 'Project Innovate' to overcome their concerns, although even here there has been criticism of the FCA's approach (Rush, 2015). Firms taking up the challenge of providing 'simplified' advice still appear to be exceptional rather than mainstream (Budworth, 2015).

Discussion and conclusion

The story of retail advice sector reform in the UK has been one of seeking to secure an affordable, professional advice service that is driven by consumer demand. At times it has felt like a search for the '*holy grail*'. Certainly, there is a group of consumers who are more engaged in seeking out financial products that meet their needs. Government pensions and savings policy is pushing more people in this direction, reflected by increasing 'DIY' investing. However, engagement is not the same as capability. Complexity, awareness and lack of interest, as well as levels of numeracy and literacy, are barriers to engagement. The litany of financial problems that populate financial pages illustrate the problems that even 'experienced' retail investors encounter.

Whilst the rise of the internet means there is a lot more help out there for individual investors to be 'guided' towards a solution, this is not regulated advice as defined. Nevertheless, the assistance provided would, in many instances, appear to employ a significant amount of the skill and expertise that one would expect to be employed by a financial adviser in the process of leading to a personal recommendation to a client. This leads to the broader question – what is financial 'advice'? In this discussion it has been suggested that, in practice, references to 'advice' can cover a 'continuum' ranging from the provision of information right up to 'independent' advice. What is clear from the evidence is that using an array of terminology and definitions has made the position complicated and more difficult, both for consumers and advisers. This also creates problems for a regulator attempting to alter the supply and demand dynamics in the retail advice sector.

If we are to avoid this state of affairs, perhaps the more significant task is to enhance the ability of consumers and providers of 'advice' services both to act responsibly and accept responsibility for their actions (Clayton et al. 2013:10). Here, regulatory definitions of advice are important to the extent they circumscribe responsibility for outcomes, and so need to be clear and commonly understood by all concerned. One lesson of previous retail financial services scandals is that consumer perceptions and understandings about 'advice' and the behaviour of advisers at the time 'advice' is provided can be quite different from their perceptions and understandings when the outcomes of that encounter become apparent (Clayton et al. 2013:10). That is why clarity and consumer understanding about the nature of advice is so important, and why the current lack of clarity presents such a potential (future) problem for the retail financial services sector. At the same time, it emphasises the importance of the 'professionalisation' of the advice sector, and of efforts to improve the financial awareness and literacy of consumers. An example of responsibility arises in relation to costs. Where an industry clearly has problems in communicating clearly and simply the cost of its services, and in some cases even clearly identifying the separate costs of the products being recommended, can this be regarded as acting responsibly? Importantly, evidence suggests that for consumers to be encouraged to accept responsibility for their own actions, they need to believe those with whom they are dealing are also acting responsibly. Again, this suggests that the regulatory emphasis needs to be on responsibility, and less on economic theories of market competition.

There is also the issue of the 'advice gap' created by the RDR. Whether this is a 'regulated advice gap' or a 'guidance gap', as a matter of practice it appears that even the Government has accepted there is an 'advice' gap (HM Treasury, 2015). Put another way, it is clear there is a consumer need to rely upon the expertise of others that is not being addressed. The development and expansion of 'simplified' advice can help address the needs of many consumers who might find regulated advice unaffordable, or otherwise find themselves becoming 'DIY investors. To that extent, it can address the advice gap created by RDR. That said, until the fears of advisers in terms of the costs and responsibilities for this form of advice are adequately assuaged (and the regulator has singularly failed in this regard over the past eight years) then the success of this approach may be limited.

This advice gap has been identified by the FCA as the most important issue it faces in relation to the RDR (2015b). Again, it is not legal definitions or notions of market competition that are at the heart of this issue, but the responsibilities that advisers and their clients should be expected to assume in a ‘simplified advice’ situation.

In conclusion, it is submitted that addressing the problems facing the advice sector from the starting point of an analysis that focuses on competition, at least in relation to the advice market, is the wrong approach. The history of retail regulatory reform, and this analysis of the RDR, both confirm this to be the case. Instead, the problems of the retail sector should be approached from the perspective of agreed, and shared, responsibility for outcomes. Thus the reforms would start from the basis of establishing agreement about principles of responsibility, and then moving towards enabling and ensuring each party is able to, and does, shoulder those responsibilities.

There is an adage that if you keep doing the same thing, you keep getting the same result. Let us hope that the recent, further, review of the advice sector announced by HM Treasury (HM Treasury, 2015) does not turn out to be another proof of that adage.

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