



Implementing the Distance Marketing Directive: another compliance regime

Executive summary

The FSA has published its proposals to implement the Distance Marketing Directive. The Directive is intended to help cross-border marketing of retail financial services by harmonising information requirements and cancellation rights. However, its implementation will require firms to operate a separate compliance regime for products sold at a distance.

The basic provisions of the Distance Marketing Directive are straightforward. Where a supplier agrees in writing, by telephone or electronically to provide financial services to a consumer he must do two things: provide the consumer with some specified information about the supplier and the service or product and, in some cases, allow the consumer to cancel the contract within a prescribed period. Why, then, does the Financial Services Authority's (FSA) Consultation Paper 196 include 102 pages of amendments to the FSA handbook in order to implement these simple concepts? In this briefing we look at some of the hidden complexities of implementation and indicate what firms will need to do to comply.

FSA's approach

The FSA is faced with a dilemma in implementing the Directive: should it apply the new requirements only to distance contracts (changing the existing rules no more than necessary but requiring firms to put in place a separate compliance regime for distance contracts); or should it apply the requirements to all products and services (which would change the existing rules more than is required but would maintain a unified regime)? In most cases it has opted for the former approach. This means that firms will need to put in place procedures to identify those products that are sold by means of distant contracts.

Distance contracts

The Directive defines a distance contract as one that makes 'exclusive use of one or more means of distance

communication up to and including the time at which the contract is concluded'. Distance communication is in turn defined as 'any means which, without the simultaneous physical presence of the supplier and the consumer, may be used for the distance marketing of a service between those parties.'

Certain contracts will clearly be distance contracts, for example where the consumer receives information through the post, through the press or through internet advertising and then deals with the firm solely by post, internet or telephone. Other contracts will clearly not be distance contracts, for example where a consumer enters into the contract upon being given face-to-face advice.

However, some cases will be less obvious, such as when marketing literature regarding a product or service is available at a branch of the supplier but the literature directs the consumer to call centres or to off-site processing offices. The FSA favours a test under which a contract is not a distance contract if there is 'meaningful simultaneous physical presence' between the supplier and the consumer. The simultaneous physical presence of supplier and consumer is only 'meaningful' if at the time marketing literature is picked up from a branch the product or service in question is one on which the branch is able to advise and deal with the consumer. If it is able to advise and deal, the contract will not be a distance contract even if the customer decides not to take advantage of the facilities offered and simply fills in a form. The same principles will apply if the contract is entered into through an intermediary.

Private customers

One aspect of the different regime that will apply to distance contracts is that firms will need to apply a different definition of 'private customer'. The protections of the Directive are applicable to contracts with a 'consumer', defined in the Directive as 'any natural person who, in distance contracts covered by this Directive, is acting for purposes which are outside his trade, business or profession.' There are differences between this definition and the FSA's definition of a 'private customer'. For example, the FSA's rules allow for an individual acting in a private capacity but who is deemed expert in a particular field to be classified as an intermediate customer, whereas he would be treated as a consumer under the Directive. On the other hand, a small company classified as a private customer under the FSA's rules would not be a consumer for the purposes of the Directive.

The FSA's proposed solution is to vary the interpretation of 'private customers' in relation to distance contracts so that it includes all persons who are consumers (defined by the FSA as 'retail customers') for the purposes of the Directive. This approach will continue to allow a private customer to be opted up to intermediate customer status, but will require the firm to provide the customer with the additional information and appropriate cancellation rights that the Directive requires when concluding distance contracts with the customer.

Information requirements

When a distance contract is entered into with a retail customer, the Directive requires a firm to provide the customer with information on a number of matters. This includes information about the firm; the service being provided (including notice of any special risks involved with the investments in question); the contract with the firm (for example, when and how any contract will come into existence and its governing law); the price payable; any right to cancel the contract; and the redress mechanisms available to the customer. The requirements are not particularly onerous in themselves but firms may well find that not all of the specified information is included in their terms of business, either because it goes beyond the existing requirements (eg in the detail required in relation to the supplier and the nature of the

contract, or in describing new cancellation rights) or because terms of business were not previously required (eg for execution only business).

Firms will not necessarily have to create new terms of business. The FSA proposes to impose the additional information requirement only in respect of distance contracts and only in respect of new customers or existing customers when new services are being provided. Where additional information is required, firms may wish to create new integrated terms of business for both distance contracts and other business. Alternatively, the additional information could be included as a separate supplement. Terms of business may consist of more than one document, provided that it is clear that the documents collectively constitute the firm's terms of business and the significance of information and ease of use is not materially diminished.

In relation to packaged products, key features and other product documentation will have to be changed so that it includes the information required by the Directive (or the additional information will have to be provided separately at the same time). This will apparently be the case whether or not a distance contract is involved.

Under the existing rules, terms of business are not required where a customer enters into a transaction as a result of a direct offer financial promotion (one which contains an offer or invitation to buy a particular product or service and indicates how to respond). The FSA is therefore proposing to amend its rules relating to the content of direct offer financial promotions to ensure that the additional information required by the Directive is included. The FSA is proposing to change the rules for all direct offer promotions, on the basis that these will invariably be made at a distance.

Where a distance contract is concluded by electronic means, for example over the internet, the information requirements imposed by the Electronic Commerce Directive (set out in the FSA's specialist sourcebook on the Directive) will also apply. The two sets of information requirements are similar, but unfortunately not identical: firms therefore cannot assume that marketing and contractual materials prepared for distance sales using conventional means will also be suitable for use on the

internet. Firms providing services through the internet should also bear in mind that merely posting information on a website will not satisfy the requirement of the Directive to make certain information available 'on a durable medium'.

As well as reviewing their terms of business and marketing materials, firms will also need to look again at telephone sales procedures. The Directive does not preclude a contract being entered into over the telephone, provided that a more limited range of information is first provided to the customer. Full terms of business must then be sent immediately after the contract is concluded.

The information requirements of the Directive will apply to banks as well as investment firms. Their effect is potentially greater for banks, since the FSA currently imposes no requirements relating to banks' terms of business with their customers. However, the FSA is currently in discussions with the sponsors of the banking code with a view to amending the code so that for distance contracts for deposit-taking it contains requirements equivalent to the FSA's new pre-contract information. The FSA's rules would then be disapplied for banks complying with the banking code requirements.

Cancellation rights

The other main area in which separate compliance procedures for distance contracts will be required is cancellation rights. The Directive provides a general right for a consumer to withdraw from a distance contract for a specified period after it has been concluded. The effect of cancellation is that the contract is terminated: the firm must pay back any sums that the consumer has paid to or for the firm (less payment for any service actually provided) within 30 days of receiving the notice of cancellation; and the consumer must return to the firm any property received under the contract within 30 days of sending the cancellation notice to the firm.

An exception is a contract whose 'price depends on fluctuations in the financial market outside the supplier's control which may occur during the withdrawal period'. The FSA cannot, pursuant to the Directive, require firms to provide cancellation rights in respect of such contracts. The FSA's current rules require firms to allow

private customers the right to cancel an investment in a unit-linked life insurance policy and, if they have received advice, a collective investment scheme. The FSA will not in future be able to require firms to grant customers these rights where the contract has been concluded by distance means (although firms will be free to offer cancellation rights voluntarily).

Currently, under the FSA rules, firms have the option in certain circumstances to offer a pre-sale right of withdrawal instead of a post-sale cancellation right. The FSA is proposing to remove this option in the case of distance contracts, since the Directive requires a cancellation right to be offered. Firms will, of course, still be able to offer a pre-sale right of withdrawal in addition to the compulsory post-sale right to cancel.

The Directive will require changes to the period within which contracts may be cancelled. The period for life policies is extended from the current 14 days to 30 days (this will apply generally, not only in relation to distance contracts). A 30-day period is also required for personal pensions, but a 14-day cancellation period is specified for all other distance contracts. This will require changes to the cancellation period for contracts regulated by the Consumer Credit Act. Here, the DTI has suggested a universal 14 day cancellation period.

The Directive will require firms to offer cancellation rights in a number of situations where they are not now required. The FSA proposes to extend cancellation rights to distance contracts with retail customers for any designated investment business, even where packaged products are not involved. This would apply, for example, to a contract with a retail customer to appoint a firm as its investment manager. The FSA also proposes to apply cancellation rights to bank accounts entered into at a distance by retail customers – this would include structured deposit products.

The effect of the changes is to create a bewildering variety of cancellation rights and periods. Although the FSA is generally proposing to harmonise the administrative procedures and periods between distance and non-distance contracts, there will still be cases where the availability of cancellation rights depends on whether or not a product is sold by means of a distance contract.

Cross-border business

The Directive is intended to operate on a 'country of origin' basis. This means that the UK's implementing measures will apply to a firm operating from an establishment in the UK and marketing to or dealing with retail customers outside the UK. The FSA rules will not, however, apply to marketing into the UK from an EEA establishment outside the UK (provided that the relevant EEA state has itself implemented the Directive) as it is the rules of that state (the country of origin) that will apply. Some of the FSA's rules which fall outside the scope of the Directive will, however, continue to apply to incoming marketing materials such as those relating to derivatives and collective investment schemes.

Application

We have dealt in this briefing mainly with investment firms and banks, but the Directive will also apply to other providers of financial services. As the new regulator of general insurance selling and administration, the FSA proposes to implement the Directive in relation to these activities as part of the introduction of conduct of business rules. The FSA also considers that mortgage intermediation falls within the scope of the Directive, and it proposes to draft the final version of its mortgage sourcebook so as to be consistent with the requirements of the Directive. The DTI will be responsible for implementing the Directive for consumer lending.

Timing

The new provisions will generally come into force on 9 October 2004. However, a number of transitional provisions will be available. In particular, where the new information and cancellation rules for packaged products apply also to non-distance business, firms are given an additional year to make any necessary changes to their systems and procedures.

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