Financial Conduct Authority

Finalised guidance

Supervising retail investment advice: inducements and conflicts of interest

January 2014

Contents

1 EXECUTIVE SUMMARY

What does this report cover?

1.1 One of the central objectives of the Retail Distribution Review (RDR) was to remove the potential for adviser remuneration to distort the advice consumers receive. By ending commission payments from investment product providers (providers) to advisory firms, we wanted to help ensure that:

- providers compete on the price and quality of their products to secure distribution rather than on commission levels, and
- advisory firms are not inappropriately influenced by the payment of commission when providing advice to their customers

1.2 We wanted to check that firms were not undermining these objectives so we assessed whether:

- advisory firms were soliciting payments for entering into service or distribution agreements that could lead them to channel business to particular providers and affect the advice given to clients, and
- providers were making these payments to secure distribution of their products

Such behaviour could result in firms breaching Principle 8 (Conflicts of interest) and the COBS inducements rules.

1.3 This report sets out our finalised guidance following responses to our guidance consultation – GC13/5: Supervising retail investment advice: inducements and conflicts of interest.[1]

Responses to consultation

1.4 We received 25 responses to our guidance consultation from a range of respondents, including life insurers, asset managers, advisory firms, consumer representatives and trade associations.

1.5 We summarise the feedback we received, together with our responses to the issues identified, in the 'Summary of feedback received' document published alongside this finalised guidance. The finalised guidance should be read with the summary of feedback received.

[1] http://www.fca.org.uk/news/guidance-consultations/gc13-05-supervising-retail-investment-advice

1.6 Respondents were generally supportive of the guidance although a number of points were raised which warranted further comment. Where appropriate our finalised guidance takes into account the points raised by respondents. We did not receive any specific comments on the cost benefit analysis and do not consider any other comments received to have an impact on it. So the cost benefit analysis is unchanged. The finalised guidance supersedes the guidance consultation document (GC 13/5) and firms should refer to the finalised guidance when considering inducements and conflicts of interest.

Which firms does our finalised guidance apply to?

1.7 Although the focus of our thematic work was on life insurers and advisory firms (including networks), **our guidance is relevant to all providers of retail investment products to be sold by advisers and any advisory firm providing personal recommendations in relation to retail investment products. It includes those circumstances when payments are made by providers to unregulated third party firms that are for the ultimate benefit of an advisory firm.** The COBS inducements rules and Principle 8 apply to firms within the same group that both manufacture and distribute their own retail investment products, or where the advisory firm is an associate of the provider. These firms may find this guidance relevant. For these firms, the rule at COBS 6.1A.9R also applies.

1.8 Some respondents to the guidance consultation pointed out to us that our guidance does not apply to mortgage or protection business. Payments provided in relation to mortgage and protection business are still subject to the Principles for Businesses including Principle 8 (Conflicts of interest), and so similar considerations apply to such payments as outlined in this guidance. We expect firms to act responsibly and not attempt to circumvent this guidance by soliciting and making excessive payments for other product lines.

Joint ventures

1.9 In our guidance consultation we indicated that we had also identified concerns about certain types of joint venture arrangements between providers and advisory firms. In some cases these appeared designed to channel monies to advisory firms to secure distribution and could inappropriately influence the advice given to customers.

1.10 It is important that any joint venture between a provider and advisory firm is consistent with the RDR and designed with the end customer in mind. So we encourage any firms considering launching such joint ventures to discuss their plans with us.

What do we expect firms to do?

1.11 We are publishing this finalised guidance, together with the summary of feedback received, to help firms better understand our expectations. We expect firms to review,

and, if necessary, revise their existing agreements in light of this finalised guidance, and to do so within three months of its publication.

1.12 If we find continuing problems we will consider further action. Firms should be clear that we do not expect to see payments which result in, or could have the effect of resulting in, a channelling of business to a particular product provider. If firms are not clear whether making/receiving a payment will be in line with the inducements rules, the payment should not be made/received. **Both the provider and advisory firm are responsible for making sure any payment is compliant with the COBS inducements rules and that they are managing any conflicts fairly.**

2 FINALISED GUIDANCE

2.1 In this section we set out our finalised guidance based on the relevant rules in this area – Principle 8, the COBS inducements rules and SYSC. Firms also need to be mindful of the adviser charging rules and ensure no commissions, remuneration or benefits of any kind are paid in relation to the personal recommendations (or related services) for retail investment products.

2.2 We explain our concerns and why certain practices are likely to create conflicts of interest and result in firms not acting in their customers' best interests. This guidance sets out a number of ways, but not the only ways, firms can comply with the relevant requirements in the FCA Handbook.

2.3 This guidance is relevant to all providers of retail investment products to be sold by advisers and any advisory firm providing personal recommendations in relation to retail investment products. It includes those circumstances when payments are made by providers to unregulated third party firms for the ultimate benefit of an advisory firm. Although the thematic review did not consider firms within the same group that both manufacture and distribute their own retail investment products, or where the advisory firm is an associate of the provider, the COBS inducements rules and Principle 8 apply to these firms. These firms are also subject to the rule at COBS 6.1A.9R.

2.4 In line with the objectives of the RDR, we do not expect to see payments which could result in a channelling of business to a particular provider. Payments made/received should always enhance the quality of the service provided to customers. A provider making, or an advisory firm accepting, any payment will create the risk that such a payment is not in line with our rules. If a product provider or advisory firm wishes to take no risk in this area, it should not make or receive such a payment. The making or receiving of such payments will require both firms to satisfy themselves that they comply with the COBS inducements rules.

Principles for businesses – Principle 8 (Conflicts of interest)

2.5 We expect all firms that we regulate to undertake their business in line with our 11 Principles for businesses. Principle 8 requires that a firm must manage conflicts of interest fairly, both between itself and its customers and between one customer and another client. SYSC 10 sets out specific rules in relation to identifying and managing conflicts of interest.

2.6 SYSC 10 requires firms to take all reasonable steps to identify the types of conflicts of interest that arise, or may arise, in the course of carrying out regulated activities or ancillary services or services between the firm and a client or one client and another. Once a firm has identified an actual or potential conflict, it must maintain and operate effective organisational arrangements with a view to taking all reasonable steps to prevent conflicts of interest from constituting or giving rise to a material risk of damage to the interests of its clients.

2.7 We are concerned with both potential and actual conflicts. If a firm is in a situation where it could receive a benefit but has yet to receive it, we believe this is enough to impair the judgement of that firm, so the potential conflict needs to be managed in the same way as an actual conflict.

2.8 Any payments or non-monetary benefits made by providers to advisory firms connected with distribution give rise to the risk of conflicts of interest as they may incentivise a firm to act in a way that is not in the best interests of its customers.

2.9 Should the payment or non-monetary benefit be offered or accepted the resulting conflicts are effectively managed if the risk of the firm putting its own interests ahead of the client is removed. Advisory firms and providers should ensure that the risk of conflicts through offering or accepting any benefits (monetary and non-monetary) is effectively managed so that accepting these payments does not impair their duty to act in the best interests of their customers. Our inducements rules in COBS 2.3 recognise that some payments or benefits offered and accepted by firms can be in clients' best interests, and that the conflicts arising can be managed so that there is no risk of the clients' interests being harmed. We discuss this further in the section of the guidance headed 'COBS inducements rules' starting at paragraph 2.14. There are some situations, however, where the only effective way to protect clients' interests is for the relevant agreements to be terminated or simply not entered into.

Panel selection and exclusive single provider deals

2.10 Where an advisory firm operates a panel of providers, the inclusion of providers on the panel should not be influenced by the provider's willingness and ability to purchase significant services from, or provide other benefits to, the advisory firm. To do so is likely to result in a breach of Principle 8 because receiving payments or benefits may unduly influence the panel selection and lead to the advisory firm putting its commercial interests ahead of its customers' interests. This applies to selecting providers for both independent and restricted panels.

2.11 Exclusive distribution arrangements that advisory firms have with a single provider can lead to conflicts. This is the case where the selection of the provider is influenced by sizeable payments or benefits the provider offers through service or distribution agreements and results in advisory firms putting their commercial interests ahead of their customers' interests.

The potential for influencing personal recommendations

2.12 Service and distribution agreements should not be constructed so that they could influence inappropriately the personal recommendations made by advisory firms.

2.13 The following examples of poor practices, identified in our review, have the potential to influence inappropriately personal recommendations. This could create conflicts, which we do not think firms would be able to manage fairly and, therefore, they are likely to breach Principle 8:

(i) Longer term multi-year agreements between providers and advisory firms will have more potential to create conflicts of interest than short-term agreements. These agreements often represent a significant revenue stream for the advisory firms concerned, and if the advisory firm relies on the ongoing revenue generated from such agreements to sustain its business, this is likely to create conflicts of interest that cannot be effectively managed.

(ii) Clauses that allow the provider to negotiate a reduced level of payments for a reduced level of services if the provider loses its place on the advisory firm's panel, or where there is a material reduction in sales of the provider's products. Any such contract would be likely to influence inappropriately the advice given to customers (i.e. advice is not in customers' best interests), as the advisory firm could lose income where it failed to recommend and arrange the sale of the provider's products in sufficient volume.

(iii) Contracts between providers and advisory firms for services that result in advisory firms obtaining payments from providers that exceed the reimbursement of costs incurred, and are linked (whether directly or indirectly) to distribution of the provider's products.

(iv) Staff in advisory firms' functions that are responsible for providing information and guidance to advisers on the benefits and features of products, also having responsibility for negotiating and providing services to providers. This would create conflicts which we do not consider can be managed effectively because staff in these functions might be unduly influenced to 'push' the products of those providers paying for services, and to discount those products from providers not purchasing services.

COBS inducements rules

2.14 We recognise that some payments or benefits offered by providers to advisory firms can be in customers' best interests, and any conflicts arising are of a nature that they can be managed.

2.15 The COBS inducements rules ban the provision or receipt of any fees, commissions or non-monetary benefits, that relate to designated investment business carried on for a client, which:

- impair the firm's duty to act in the best interests of its client
- are **not** designed to enhance the quality of service provided to a client
- are **not** clearly disclosed to clients – with some exceptions for non-MiFID business

2.16 COBS 2.3.15G gives guidance on the type of benefits that are capable of enhancing the quality of service provided to a client and, depending on the circumstances, are capable of being paid or received without breaching the client's best interests rule.

2.17 Our review identified payments made by life insurers to advisory firms for specific services that were primarily justified by firms as being acceptable because they were considered as falling under the table of reasonable non-monetary benefits in the guidance given in COBS 2.3.15G. Often firms took an overly broad interpretation of this guidance to justify a wide range of benefits that in our view did not meet the inducements rules. We expect firms to assess whether each benefit complies with the inducements rules, before providing or accepting any such benefit, irrespective of whether the benefit is included in COBS 2.3.15G.

2.18 It may be difficult for a provider to determine whether making such a payment would impair the advisory firm's duty to act in the best interests of its clients, or whether the payment made is in line with the costs incurred by the advisory firm. If the provider is not able to satisfy itself that making the payment would comply with the rules, the payment should not be made.

2.19 There were some common features of the types of benefits identified in our review that we considered did not give rise to conflicts, i.e. the benefit:

- was reasonable and proportionate
- was of a limited scale and nature (taking into account any other benefits offered or accepted)
- did not need to be relied upon by the advisory firm in the future in order to continue to service its clients (so that should the benefit cease to be provided, the impact on the advisory firm or its clients would not be significant)
- could reasonably not be expected to result in the channelling of business from the advisory firm to the provider, and
- did not result in the advisory firm recovering more than its reasonable costs

Reimbursement of costs

2.20 Unless stated otherwise in the table of reasonable non-monetary benefits in COBS 2.3.15G, we do not expect payments from providers to advisory firms for services related to designated business to represent anything other than the reimbursement of costs incurred by advisory firms in providing the services. Payments that go beyond the reimbursement of costs are likely to create unmanageable conflicts of interest in the advisory firm, and could lead to the channelling of business to those providers who are willing and able to make significant payments to advisory firms.

Disclosure

2.21 The COBS inducements rules require any payment or benefit paid or received by a firm, that is related to designated investment business to be disclosed to customers (unless it is related to non-MiFID business and falls within the table of reasonable non-monetary benefits at COBS 2.3.15G). Our thematic work identified some firms, both providers and advisers, failing to disclose such payments or benefits under service or distribution agreements – the COBS inducements rules require providers to disclose the payments made, and advisers the payments received. These include, but are not restricted to payments for management information, data and research.

2.22 We expect firms to comply with our disclosure rules as set out in COBS 2.3 and to ensure this disclosure is clear, fair and not misleading and provided to clients before the provision of the service. Such disclosure allows clients to make their own judgement about the nature of payments or benefits and how this could influence the service they are receiving.

2.23 The rest of this section gives guidance on payments from providers to advisory firms for specific services that we have seen in our review.

IT development and maintenance

2.24 Guidance in COBS 2.3.15G paragraph 10 states that a product provider may pay cash amounts or give other assistance to a firm not in the same immediate group to develop software or other computer facilities necessary to operate software supplied by the provider, but only if it will generate equivalent cost savings to itself or clients.

2.25 The following examples of poor practices, identified in our review, create conflicts of interest that are likely to cause an advisory firm to put its commercial interests ahead of the best interests of clients by channelling business to providers willing to make such payments rather than to providers with suitable products. Such payments are not in line with the COBS inducements rules:

- payments, or other assistance from providers to advisory firms for developing software or other computer facilities that go beyond that which is required to operate software supplied by the provider
- payments from providers to develop advisory firms' general IT systems or infrastructure, and

- annual payments from providers for advisory firms' general IT maintenance

2.26 For these reasons we consider payments from providers to advisory firms for IT development and ongoing maintenance should be restricted to only those costs that are necessary to integrate and feed information into a provider's IT systems. Furthermore, these payments would need to satisfy the following conditions:

- providing or receiving a payment does not impair the firm's duty to act in the best interests of its clients
- the payments can reasonably be expected to result in equivalent cost savings to the provider or its clients
- the quality of service received by the client can reasonably be expected to be enhanced by, for example, automating business processes to reduce the possibility of errors arising from manual processing and the time taken to process business

Training

2.27 Guidance in COBS 2.3.15G paragraph 13 states that a provider may provide an advisory firm with 'training facilities of any kind (for example, lectures, venue, written material and software)'. To comply with the inducements rules the quality of service to the client must be enhanced as a result of such payments. We would also expect UK-based advisers to receive training in the UK and the advisory firm should only seek the reimbursement of the reasonable costs incurred in providing the training. If there is any hospitality provided we expect our rules and guidance on hospitality payments to be followed as set out in the *Hospitality and gifts* section at paragraph 2.35.

2.28 A provider giving an advisory firm training on the features and benefits of its products or services, or subject areas relating to the adviser's continuing professional development (CPD), is unlikely to impair its compliance with the client's best interests rule if the training is made reasonably available to all advisory firms that could recommend the provider's products or services on an equal basis, even if only on a first-come, first-served basis, as set out in COBS 2.3.16G.

2.29 We recognise that it can be cost effective for advisory firms to hold training events where providers deliver training on their products, and in these circumstances it is reasonable for the providers to share in the costs of arranging such training, provided it is UK-based. However, providers should be willing to offer similar training and associated payments to other advisory firms in accordance with COBS 2.3.16G. We do not expect the provision of training to result in a channelling of business to a provider or be dependent on appearance on a panel.

Conferences and seminars

2.30 Guidance in COBS 2.3.15G paragraph 7 states that 'a provider may take part in a seminar organised by an advisory firm (or a third party) and pay towards the cost of the seminar if its participation is for a genuine business purpose and the contribution is

reasonable and proportionate to its participation and by reference to the time and sessions at the seminar when its staff play an active role'.

2.31 The following examples of poor practices, identified in our review, have the potential to create conflicts of interest. They are also unlikely to be in the best interests of clients, and if that were the case would breach the inducements rules:

- Excessive payments from a life insurer to an advisory firm to take part in the advisory firm's annual conference. The payments did not reflect the time and sessions at the conference when the life insurer's staff were likely to play an active role, given that participation merely involved the life insurer having a presentation stand at the conference and co-hosting a dinner for a relatively small number of advisers.
- A life insurer calculating the contribution it made to an advisory firm for attending its seminars and conferences, by reference to how much it might have cost to have face-to-face meetings with each of the individual advisers attending. We considered that this resulted in a significantly larger payment than warranted by the time that the life insurer's staff played an active role in the seminar or conference.
- Advisory firms seeking the recovery of all costs incurred in running seminars and conferences from providers, rather than being a contribution designed to recover the costs associated with the life insurer's active participation.

2.32 An 'active' role requires more than just attendance, and more than simply having the opportunity to network with adviser attendees at the event. An active role involves presenting to the advisers at the event, and a provider would only be likely to get a genuine business benefit and the quality of service to clients would only be likely to be enhanced if the aim was to inform advisers on the features and benefits of its products or services or legislative/technical matters relating to its products or services.

2.33 We would also question whether the quality of service to clients would be enhanced in those circumstances when a provider is on a restricted panel of the advisory firm, especially if the panel is restricted to a small number of providers, or if it was a sole provider arrangement. Advisers will already be aware of these products (as part of the training they received when the panel was created), and as a restricted adviser will only be able to advise clients on those products, there would not appear to be an obvious benefit to providers from contributing towards the costs of the seminar/conference. However, if a firm is independent, and the advisers are not restricted to selling a particular provider's products, there is more likely to be a benefit to the provider in participating and contributing towards the costs of a seminar/conference and for the quality of service to clients to be enhanced as a result.

2.34 Any proportionate contribution made by a provider should be calculated by reference to:

- the overall cost to the advisory firm in organising the event;
- the time allotted to the provider for presenting; and
- the number of advisers attending the presentation.

Such contributions should only cover a portion of the overall costs incurred by the advisory firm, and we would always expect the advisory firm to pay a significant majority

of the overall costs of a seminar or conference. If an advisory firm holds its conference/seminar outside the UK, we would not expect the advisory firm to be able to recover any of the costs of this event from providers, although providers can attend the event if required.

Hospitality and gifts

2.35 Guidance in COBS 2.3.15G paragraph 1 states that a provider may give, and an advisory firm may receive, hospitality, gifts and promotional competition prizes of 'a reasonable value'. As with other payments, any such payment should enhance the quality of the service provided to the client.

2.36 Our review identified a range of events that involved providers offering hospitality, and providing gifts/prizes to advisers. In some cases the amounts paid by the provider appeared to us to be of 'an unreasonable value' in the specific circumstances in which they were made and could have led to a channelling of business to that provider.

2.37 Where we considered the payments satisfied the reasonable value test, and the other requirements of the COBS inducements rules, a number of key characteristics were evident:

- The event at which the hospitality was provided was located in the UK.
- Adviser attendance at the event where the hospitality was provided was not based on criteria that incentivised poor behaviours, e.g. it was not based on the volume of business generated by the adviser for the provider's product(s).
- The event was designed for business purposes, such as product training, that resulted in advisers being able to provide a better service to their customers.
- Payments for food and drink were proportionate and not extravagant and any overnight accommodation was only paid for where necessary, e.g. where the event was run over two days, or the location meant that travelling on the day of the event was impractical for advisers.
- Providers had calculated the 'per head' costs of the hospitality provided, and assessed the reasonableness of these costs against previously agreed monetary limits set by an appropriate committee and verified by a 'second-line' function in the provider, e.g. the compliance department.
- Promotional prizes were not extravagant and were linked to activities that increased knowledge of a provider's products or other services offered.
- Gifts were not extravagant and were not based on criteria that incentivised poor behaviours.
- Providers had maintained a log of all hospitality and gifts provided to advisers over a specified period so that cumulative payments to individual advisers did not exceed previously agreed limits (both monetary amount and number of occasions). Such logs

were regularly reviewed by the sales and marketing functions to ensure adherence to limits, and independently audited by compliance on a periodic basis.

2.38 In assessing the reasonableness of the amounts paid to advisory firms for hospitality, gifts and promotional prizes, providers should consider whether the payments display these characteristics. Payments that display these characteristics are likely to comply with the COBS inducements rules, whereas payments which are not in line with these principles are likely to be in breach of the COBS inducements rules.

2.39 Our expectation is that providers and advisory firms should have a clearly defined policy, approved by an appropriate Approved Person (or Board Committee) for determining what constitutes reasonable hospitality and for authorising the provision or acceptance of such hospitality. Such authorisation is likely to involve more senior approval for higher levels of payments. It should also include processes and controls for ensuring such hospitality does not have the potential to unduly influence advisory firms in their selection of providers and result in the channelling of business to the provider offering the hospitality.

Promotional activity

2.40 Guidance in COBS 2.3.15G, paragraph 2 states that a provider may assist an advisory firm to promote its products so that the quality of its service to clients is enhanced. Such assistance should not be of a kind or value that is likely to impair the advisory firm's ability to pay due regard to the interests of its clients, and to give advice on, and recommend, products available from its whole range or ranges.

2.41 Guidance in COBS 2.3.15G, paragraph 6 states that a provider can supply draft articles, news items and financial promotions for publication in an advisory firm's magazine, only if in each case any costs paid by the provider for placing the articles and financial promotions 'are not more than market rate, and exclude distribution costs'.

2.42 We were concerned that in some instances providers were determining the market rate based on what 'everyone else had to pay to the advisory firm'. In our view, the market rate had been skewed in these instances and had led to sizeable payments resulting in the potential for firms to put their commercial interests ahead of their customers' interests. Providers should determine a market rate based on more objective criteria, for example by reference to what they might have to pay a relevant trade publication or other suitable media for a financial promotion aimed at their target market.

2.43 Providers paying a market rate to an advisory firm for placement of their financial promotions may lead to significant revenues for that advisory firm, creating potential conflicts of interest. Therefore, if a market rate is paid, firms need to demonstrate how this has been derived and why the revenue generated has not caused a conflict of interest. Advisory firms and providers should also consider whether ongoing promotional activity carried out in a given period could inhibit their ability to act in the best interests of clients. This could potentially occur when payments in aggregate are substantial and represent a key source of revenue for the advisory firm.

2.44 Another way for advisory firms to comply with the inducements rules and manage conflicts of interest effectively is to restrict payments from providers for placing financial promotions to the reimbursement of the costs incurred by the advisory firm.

2.45 If a restricted panel of providers is created by an advisory firm/network (especially when that panel is restricted to a small number of providers, or if it is a sole provider arrangement), we consider it less likely for there to be the need for significant payments to be made in connection with the advisory firm/network promoting the providers' products to its individual advisers. As the advisory firm has limited its advisers to recommending products from a small number of providers, advisers are more likely to be already aware of the providers' products on the panel and we would expect awareness of these products to be part of the ongoing training of the advisers.

Meetings between providers and advisory firms

2.46 Our review identified some agreements under which advisory firms charged providers for regular and structured meetings with their senior management team. It appeared to us that these meetings were of commercial value to both the advisory firms and the providers as they were, for example, for discussing matters such as the progress on joint marketing initiatives and new business opportunities.

2.47 Payments from providers for such meetings have the clear potential to cause the advisory firm to put its commercial interests ahead of the best interests of its customers by recommending the products of those providers willing to pay for such meetings rather than other providers with equally suitable products that are unwilling to pay. We do not consider payments for such meetings are capable of meeting the requirements of the inducements rules.

Management information (MI), data, and research services

2.48 Our review identified agreements under which providers paid advisory firms for MI, data and research, with the aim of increasing the sales of investment products through those advisory firms. Such MI can also provide useful feedback to providers on who is buying their products, and feed into their product review and design processes (see for example, *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers* [1]).

2.49 As mentioned in paragraph 2.20 we consider payments by a provider to an advisory firm for providing most services (which includes MI, data and research) should be restricted to reimbursing the costs incurred by the advisory firm. Providers purchasing information of this type from advisory firms must derive genuine business benefit from it, and both providers and advisory firms must be able to demonstrate that it is expected to enhance the quality of service to clients.

[1] http://media.fshandbook.info/Handbook/RPPD_20130401.pdf

Services outsourced to advisory firms

2.50 Our thematic review identified a number of providers 'outsourcing' certain services to advisory firms that might typically have been performed by broker sales consultants within the providers. Such outsourced services included training on the providers' IT new business systems and processes, and the performance of sales and campaign management services to ensure advisers were generating anticipated levels of quotes and where they were not, the reasons why this was the case and any follow-up work required.

2.51 We consider any payments from a provider to an advisory firm for procuring such services relating to designated investment business are subject to the inducements rules at COBS 2.3. As such, firms must satisfy themselves that they are complying with these rules and guidance on the procurement of, and payment for, these services.

Systems and controls

2.52 Principle 3 requires a firm to take reasonable care to organise and control its affairs responsibly and effectively, with relevant risk management systems. Under SYSC 3.1.1R a firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business. Under SYSC 6.1.1R a firm must establish, implement and maintain adequate policies and procedures sufficient to ensure compliance with its obligations under the regulatory system.

2.53 We came across some service or distribution agreements where firms could demonstrate that they had effective arrangements in place to ensure compliance with the relevant rules. These arrangements displayed a number of features:

- Agreements had been entered into by providers following a detailed analysis of the services offered by advisory firms to ensure compliance with the relevant rules.
- Providers had established and documented clear policies on distributor spending to provide an effective governance framework.
- Adherence to these policies was overseen by relevant executive committees (with independent challenge from risk and compliance), with any breaches recorded and escalated in accordance with the firm's established processes.
- The negotiation of service or distribution agreements between providers and advisory firms, and the decision making on these, was separate from the process of securing placement on advisory firms' panels.
- Controls were in place in the advisory firms to ensure that benefits from providers did not affect personal recommendations.
- The boards of firms had been actively engaged in the process for entering into agreements and they (or a delegated committee) had approved the contractual arrangements.

2.54 Arrangements that displayed these features helped mitigate the risk to firms of reputational damage and/or regulatory censure for breaches of relevant rules. They also helped ensure that spending by providers on services offered by advisory firms was not dependent on, linked to, or made a condition of, the introduction of future new business or the retention of existing business.

ANNEX 1: Cost benefit analysis

1. As we are not making any new rules, our statutory cost benefit analysis (CBA) requirements do not apply. However, we have committed to consider conducting and publishing an analysis of the costs and benefits of any guidance that is likely to result in firms or consumers incurring significant costs that were not formally considered when we consulted on the rules or the principles the guidance relates to.

2. The guidance on *Supervising retail investment advice: inducements and conflicts of interest* may impose some costs. This annex considers these costs and explains why we consider the benefits justify making this guidance.

Costs

Costs to firms

3. This guidance seeks to support the original RDR objectives, rather than establish new policy, so many of the costs that firms may incur have already been estimated in the original RDR CBA. We do not consider that we should account for costs incurred by firms knowingly trying to undermine the RDR's objectives, so the costs to firms of correcting agreements that do not meet the relevant rules are not included.

4. The only additional costs incurred by firms as a consequence of this guidance would comprise those relating to the review of existing service or distribution agreements to ensure compliance, and the implementation of improved systems and controls to maintain compliance. Firms are likely to incur some costs by undertaking the following activities:

    (i) **Review of existing service or distribution agreements:** all firms with these agreements are likely to incur some costs in reviewing them. In a minority of cases, we anticipate that firms might incur costs by seeking external legal advice on whether existing agreements need to be revised or terminated to comply with the relevant rules.

    (ii) **Review of current systems and controls:** firms may decide to review their current arrangements for establishing and maintaining service or distribution agreements after considering our proposed guidance. This may result in changes to procedures to manage conflicts of interest effectively and increased monitoring, which may result in increased costs.

5. We do not expect these costs to be material because most firms already have policies and controls in place to comply with the relevant rules in this area, and are likely to incur only minimal costs in adapting these as a result of the proposed guidance. Based on the agreements we have seen in our review, we might typically expect a firm's legal function to spend a day reviewing an agreement against this guidance, and for its compliance function to spend a further two days reviewing the effectiveness of its systems and controls to manage conflicts of interest. We have estimated the per agreement costs,

therefore, to be around £1,000[2]. This would rise significantly if a firm chose to seek external legal advice on the regulatory compliance of its service or distribution agreements.

Costs to consumers

6. We do not anticipate that the guidance will result in consumers incurring any costs.

Costs to the FCA

7. While there could be an opportunity cost from supervisory time being spent assessing firms' policies and associated governance and controls relating to service or distribution agreements, we expect this to be included in normal supervisory activities. Additionally, the increased clarity of our requirements may lessen the time our supervisors need to spend assessing firms' systems and controls in this area. As such, we expect any incremental costs to the FCA to be very small.

Benefits

8. We expect action taken by firms following the guidance will result in the further realisation of the benefits envisaged in PS10/06 (*Distribution of retail investments: Delivering the RDR*[3]). In particular, by providing guidance on the types and levels of benefits that can be offered by providers to advisory firms, we envisage a reduction in the risks of provider bias. It is beyond the scope of this paper to estimate the precise incremental benefits realised by this guidance. However, without further clarification there is a risk that previously estimated benefits do not fully materialise.

9. The benefits envisaged in PS10/06 were quantified (in terms of the annual customer harm arising from inappropriate advice from advisers 'motivated by income generation', rather than acting in the best interests of their customers). This amounted to £223m based on the unsuitable sales of certain investment products. Since then we have undertaken an analysis of customer harm in relation to inappropriate advice given in relation to Arch Cru funds, and have extrapolated the figure included in PS10/06 to all investment products sold in the market. This indicates that the annual detriment arising from the sales of unsuitable products could be in the range of £0.4bn to £0.6bn.

10. The anticipated incremental benefits (although not quantified) arising from our guidance are expected to outweigh the anticipated costs.

[2] Staff salaries have been taken from the FSA compliance cost survey 2006, Hudson Legal Salary Guide 2012 and Hudson Banking & Financial Services 2012 salary guide. All figures have been adjusted for inflation when appropriate and include firm overheads

[3] http://www.fca.org.uk/your-fca/documents/policy-statements/fsa-ps10-06