Financial Conduct Authority

Guidance consultation

Supervising retail investment advice: inducements and conflicts of interest

September 2013

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 customers, 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 inducements rules.

1.3 This report sets out the findings of our thematic supervision work on the payments made by life insurers to advisory firms under service or distribution agreements. It also sets out guidance for consultation on how such agreements can breach Principle 8 and the inducements rules and so undermine the objectives of the RDR.

What did we find in our thematic review?

1.4 The results of our thematic review highlighted serious concerns and a poor management culture in some firms whose actions have the effect of undermining the objectives of the RDR.

1.5 Just over half the firms we sampled had agreements that we considered could breach Principle 8 and the inducements rules and so undermine the objectives of the RDR.

1.6 This may mean that the customer benefits of the RDR are not being fully realised in some firms as advice to customers may be inappropriately influenced by the existence of such agreements.

1.7 We also identified, through our wider supervisory work, concerns about certain types of joint ventures between providers and advisory firms where the terms of the arrangements were not consistent with the objectives of the RDR.

Which firms does our proposed guidance apply to?

1.8 Although the focus of our thematic work was on life insurers and advisory firms (including networks), **our proposed guidance is relevant to all providers manufacturing retail investment products for 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.** It does not 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. Under these circumstances the rule at COBS 6.1A.9R applies.

What do we expect firms to do?

1.9 We have taken early action and provided feedback to firms following our review. Many agreements have been changed as a result to address our concerns. Two firms have been referred to Enforcement for potential rule breaches.

1.10 Given the issues we found across the market, we are publishing this guidance consultation to help firms further understand our expectations. We expect firms to review, and, if necessary, revise their existing agreements in light of the final guidance we publish following consultation.

1.11 We will carry out supervisory follow-up work to check whether firms have acted on our guidance. If we find continuing problems we will consider further action.

2 OUR FINDINGS

How did we carry out our review?

2.1 We wrote to a sample of life insurers and advisory firms setting out our concern that some firms may be trying to undermine the RDR rules. In particular, we were concerned that they may be soliciting or providing payments, or other benefits, that did not look like traditional commission, but were intended to achieve the same outcome, i.e. to secure distribution.

2.2 We asked each firm to provide us with their top five service or distribution agreements by amount payable or receivable. In total we received and reviewed 80 agreements. These included agreements not only between advisory firms and life insurers, but also agreements between advisory firms and other investment firms such as platforms and asset managers, and agreements between life insurers and other distributors such as building societies, employee benefit consultants and compliance consultancies supplying services to advisory firms.

What did we find?

Payments to secure distribution

2.3 Our review identified a number of life insurers paying benefits to advisory firms, which appeared to be linked to securing sales of their products or services. Any arrangement that enables a provider to secure distribution by paying monies and providing other benefits to an advisory firm could inappropriately influence the advice received by a customer and cause a firm to breach Principle 8 (Conflicts of interest) and the COBS inducements rules.

2.4 For some service or distribution agreements we found a positive correlation between the level of payments made by life insurers to advisory firms and placement on their advice panels.

Example 1 – securing placement on an advice panel

An advisory firm had secured substantial payments from a number of life insurers for providing support services, such as promoting their products and arranging training events. These life insurers (and no others) had also been selected to be included on the advisory firm’s advice panels for investment products.

The process the advisory firm had used for panel selection gave it significant leeway to select life insurers that were purchasing services, and to discount those life insurers that offered suitable products but did not purchase the support services it offered.

2.5 Our review identified a significant increase in overall spending by life insurers for support services offered by some advisory firms in the lead up to, and following, the implementation of the RDR. This was due to a combination of increased spending on existing services and the purchase of new services, particularly for data and research. In some cases the increased spending on support services did not appear to be commensurate with the benefit obtained by the life insurer or its customers. Nor did it appear to enhance the quality of service to customers in many cases.

Example 2 – significant increases in payments with little justification

A life insurer significantly increased its spending on support services offered by an advisory firm with little justification of the business benefit obtained and the steps taken to ensure a reasonable amount was being paid. Also, the terms of the service agreement provided for a sizeable increase in the services purchased in successive years.

Payments that have the potential to inappropriately influence personal recommendations

2.6 We identified some agreements that potentially incentivised advisory firms to promote a particular provider's products or services among their advisers, creating a risk that personal recommendations provided to customers could be driven more by an advisory firm's commercial considerations than the best interests of its customers.

2.7 We found inadequacies in the systems and controls that some advisory firms had put in place to manage the potential conflicts of interest created by service or distribution agreements.

Joint ventures

2.8 We 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 had the potential to inappropriately influence the advice given to customers.

Example 3 – a joint venture arrangement creating conflicts of interest

This involved a proposed agreement between a provider and advisory firm to jointly establish a new investment proposition. Under the proposed terms the provider would have paid a substantial upfront payment to the advisory firm. The advisory firm would have also received a greater proportion of the profits from the venture compared to its input into the arrangement, and its entitlement to profits would increase the more business that was channelled to the joint venture.

Given the inherent conflicts of interest involved, we also questioned whether the advisory firm could fulfil the requirements to be considered independent if it recommended funds it had a role in manufacturing.

As with similar joint venture-style agreements we reviewed, we prevented the arrangement going ahead in that form.

2.9 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.

2.10 We will continue to monitor market developments closely and if we find firms are using joint venture agreements to preserve undesirable features of the market the RDR sought to address, we will take appropriate action.

Examples of good practice seen in our review

2.11 Our review also identified good practices, where we considered firms had complied with the COBS 2.3 inducements rules and had implemented controls to manage any conflicts of interest created by their service or distribution agreements.

Example 4 – payments for IT development that complied with our rules

An advisory firm was able to demonstrate that payments made by the provider for developing its IT systems covered the costs of integrating the respective new business systems only and resulted in anticipated equivalent cost savings for the provider. It also demonstrated that integrating the IT systems was designed to enhance the quality of service to customers by streamlining and automating processes and reducing the possibility of errors in the application processes.

Example 5 – payments for training that complied with our rules

We reviewed agreements where the provider contribution to a training event was designed to recover the costs incurred by the advisory firm of organising and arranging for the provider's active participation at the training event. The training was designed to enhance the quality of service provided to customers, and the provider had made it generally available to other advisory firms.

Some firms set out for us, in some detail, the nature and purpose of the training and the intended audience, together with the associated cost so we could clearly see the training was for a genuine business purpose and that the cost appeared reasonable and proportionate to the provider's participation. In many cases providers had benchmarked the training costs, e.g. on a per adviser basis, to determine the reasonableness of contributions requested from advisory firms.

3 GUIDANCE FOR CONSULTATION

3.1 In this section we set out our expectations of firms based on the relevant rules in this area – Principle 8, the COBS inducements rules and SYSC.

3.2 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.

3.3 This proposed guidance is relevant to all providers manufacturing retail investment products for 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. It does not 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. Under these circumstances the rule at COBS 6.1A.9R applies.

Principles for businesses – Principle 8 (Conflicts of interest)

3.4 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 the identification and management of conflicts of interest.

3.5 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 to identify and take all reasonable steps to prevent conflicts of interest from constituting or giving rise to a material risk of damage to the interests of its customers.

3.6 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.

3.7 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 inconsistent/diverges from the interests of its customers.

3.8 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 customer 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 customers' best interests, and that the conflicts arising can be managed so that there is no risk of the customers' interests being harmed. We discuss this further in the section of the report headed 'Inducements rules' starting at paragraph 3.13. There are some situations, however, where the only effective way to protect customers' interests is for the relevant agreements to be terminated.

Panel selection and exclusive single provider deals

3.9 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 if the conflict is not fairly managed because the receipt of 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 the selection of providers for both independent and restricted panels.

3.10 Exclusive distribution arrangements that advisory firms have with a single provider can give rise 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

3.11 Service and distribution agreements should not be constructed so that they have the potential to inappropriately influence the personal recommendations made by advisory firms to act in the best interests of their customers.

3.12 The following examples of poor practices, identified in our review, have the potential to influence personal recommendations thereby creating conflicts, which may breach Principle 8 if not fairly managed:

(i) Longer term multi-year agreements between providers and advisory firms may 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 is reliant on the ongoing revenue generated from such agreements to sustain its business, this has greater potential to create conflicts of interest.

(ii) Clauses that allow the provider to negotiate a reduced level of payments for a reduced level of services in the event that 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 has the potential to inappropriately influence 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 generate a profit for advisory firms and are linked (whether directly or indirectly) to distribution of the provider's products. Our rules do not prevent advisory firms from earning a reasonable profit (by charging a market rate) on services supplied to providers, but any profit increases the potential to create conflicts that need to be managed by firms. Our concern about conflicts is heightened when the profit generated by providing specific services for providers is significant, as the greater the profit, the greater the risk that the advisory firm may recommend a particular provider's product which may not be in the customer's best interests.

(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 the negotiation and provision of services to providers. This may create conflicts 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.

Inducements rules

3.13 We recognise that some payments or benefits offered by providers to advisory firms can be in customers' best interests, and the conflicts arising can be managed. Further detail on this is given in the inducements rules at COBS 2.3.

3.14 The 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

3.15 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.

3.16 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 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.

3.17 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 on by the advisory firm in the future in order to continue to service its customers (so that should the benefit cease to be provided, the impact on the advisory firm or its customers would not be significant), and
- could reasonably not be expected to result in the channelling of business from the advisory firm to the provider

3.18 The inducements rules require any payment or benefit paid or received by a firm to be disclosed to customers (unless it is related to non-MiFID business and falls within the table of non-monetary benefits at COBS 2.3.15G). Our thematic work identified a number of firms that were failing to disclose such payments or benefits under service or distribution agreements.

3.19 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. Such disclosure allows customers to make their own judgement about the nature of payments or benefits.

3.20 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

3.21 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 for the development of software or other computer facilities necessary to operate software supplied by the provider, but only to the extent that by doing so it will generate equivalent cost savings to itself or clients.

3.22 The following examples of poor practices, identified in our review, have the potential to create conflicts of interest and are unlikely to be in the best interests of customers, and so are likely to breach the inducements rules:

- Payments from providers to develop advisory firms' general IT systems or infrastructure. Such payments have the clear potential to create conflicts and cause an advisory firm to put its commercial interests ahead of the best interests of customers by channelling business to providers willing to make such payments rather than to other providers with suitable products.
- Similarly, sizeable annual payments from providers for general IT maintenance have the potential to create conflicts of interest in the same way.

3.23 For these reasons we consider payments from providers to advisory firms for IT development and associated ongoing maintenance that are restricted to only those costs that are necessary to integrate and feed information into a provider's IT systems are more likely to be acceptable if:

- providing or receiving such a payment does not impair the firm's duty to act in the best interests of its customers
- the payments can reasonably be expected to result in equivalent cost savings to the provider or its customers
- the quality of service received by the customer 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

3.24 However, payments from providers towards the wider development of an advisory firm's IT systems or infrastructure, where such development is needed before the advisory firm's systems can be integrated with a provider's, are likely to be of such a scale and nature that they cause conflicts of interest that are not in customers' best interests.

Training

3.25 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)'.

3.26 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 customer's best interests rule if the training is made available to all advisory firms who could recommend the provider's products or services, even if only on a first-come, first-served basis.

3.27 Our rules permit providers to reimburse the reasonable costs incurred by an advisory firm or a third party that are associated with training. However, providers should not be paying advisory firms, or incentivising advisory firms through other means, to attend the training.

3.28 An example of poor practice, identified in our review, involved an advisory firm seeking a contribution from a life insurer towards the cost of organising a training workshop for its advisers. Although the life insurer was delivering a training session at the workshop the contribution requested was disproportionately high (and appeared to go beyond reimbursement of the reasonable costs incurred by the advisory firm) based on the expected low number of attendees at this training session.

Conferences and seminars

3.29 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'.

3.30 The following examples of poor practices, identified in our review, have the potential to create conflicts of interest and are unlikely to be in the best interests of customers, and so may 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.

3.31 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. A provider would only be likely to get a genuine business benefit, and the quality of service to customers would only be likely to be enhanced, if the aim was to train advisers on the features and benefits of its products or services, or legislative/technical matters relating to its products or services.

3.32 So 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 or otherwise providing training; and the number of advisers attending the presentation. Such contributions should only cover the relevant costs incurred by the advisory firm.

Hospitality

3.33 Guidance in COBS 2.3.15G paragraph 1 states that a provider may give, and an advisory firm may receive, hospitality of 'a reasonable value'.

3.34 Our review identified expensive hospitality events for advisers, some of which included seminars and training as part of the events. Sometimes these events were in overseas locations and over a period of several days, and included the spouses or partners of the advisers. The advisory firms concerned had often sought to secure 'sponsorship' of the events from one or more life insurers, so that life insurers were potentially meeting a significant proportion of the overall costs to the advisory firms of arranging the events, rather than a reasonable and proportionate contribution calculated by reference to their participation at the event. Expensive events such as these could encourage advisers to particular courses of action, for example, if attendance was related to volume of business, which may result in advisers putting their financial interests ahead of the interests of their customers.

3.35 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

3.36 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.

3.37 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'.

3.38 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'. This often 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 for a financial promotion aimed at their target market.

3.39 Providers paying a market rate to an advisory firm for placement of their financial promotions may lead to significant revenues and profits 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 any profit arising has not caused a conflict of interest – see paragraph 3.12(iii). Advisory firms should also consider whether ongoing promotional activity carried out with a provider in a given period could inhibit its ability to act in the best interests of customers.

3.40 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.

Meetings with advisory firms

3.41 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 the purposes, for example, of discussing matters such as the progress on joint marketing initiatives and new business opportunities.

3.42 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.

Management information (MI), data and research services

3.43 Our review identified agreements under which providers paid advisory firms for MI, data and research, with a view to 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]). In most cases the amounts paid included a profit margin for the advisory firm.

3.44 As mentioned in paragraph 3.12(iii), we consider that including a profit margin may increase the potential for conflicts of interest. It may be particularly difficult for firms to demonstrate that they are not making significant profit in this area as it may not be easy to establish a market rate for the information.

3.45 We consider one way for firms to comply with the inducements rules and manage conflicts of interest effectively is to restrict payments for this information to the reimbursement of the costs incurred in producing it.

3.46 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 customers. If the information could reasonably be expected to be provided by the advisory firm as part of an ongoing business relationship then we would not expect there to be a charge for it.

Systems and controls

3.47 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.

3.48 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:

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

- 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.

3.49 Arrangements that displayed these features helped ensure that payments were designed to benefit customers and mitigated 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.

4 HOW TO RESPOND TO THIS CONSULTATION

4.1 We are asking for your written responses to this consultation by close of business on 18 October.

4.2 We cannot guarantee that we will consider responses we receive after this date.

4.3 You can send your response by email to Conduct_LifeinsuranceThemes@fca.org.uk or by post to Paul McCormick, Life Insurance Department, Supervision Division, The Financial Conduct Authority, 25 The North Colonnade, Canary Wharf, London E14 5HS.

4.4 There is no need to submit a response by post as well as emailing it.

4.5 When responding, please state whether you are doing so as an individual or on behalf of an organisation. Please include your contact details with your response, in case we need more detail on any issues you raise.

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 proposed 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. We welcome comments on this analysis.

Costs

Costs to firms

3. This proposed 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 proposed 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 such 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[1]. 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 proposed 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 proposed guidance will result in the further realisation of the benefits envisaged in PS10/06 (*Distribution of retail investments: Delivering the RDR*[2]). 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 report 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 detriment 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 detriment 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 – £0.6bn.

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

11. We welcome any views or comments on the CBA for this proposed guidance including your thoughts on any costs or benefits we may have missed.

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[1] 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

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