Financial Conduct Authority

Thematic Review TR14/19

Wealth management firms and private banks

Conflicts of interest: in-house investment products

November 2014

Contents

1. Executive summary

This report presents the findings of a review of conflicts of interest arising from wealth management and private banking firms' use of in-house investment products[1] (IHPs) in retail discretionary and advisory investment portfolios. Following our work during 2013 on suitability[2] in the wealth management and private banking sector, we wanted to understand how firms identified and managed conflicts of interest in relation to IHPs.

Conflicts of interest are an issue in many sectors and an ongoing area of our regulatory focus. We set out in our Business Plan[3] and Risk Outlook[4] that we intended to look at this issue in the wealth management and private banking sector in respect of the use of IHPs. This review strengthens our understanding of the connection between firms' business models and the consumer outcomes they produce. Identifying and managing conflicts of interest is a fundamental obligation on firms and, as such, we would expect all firms to have an embedded approach to deal with conflicts of interest.

The identification and management of conflicts of interest is fundamental to market integrity and the delivery of good outcomes for customers who rely on agents to act in their best interests. These outcomes are supported by a range of relevant rules and guidance which sets out the parameters of how firms are expected to operate.

We conducted the review to assess whether wealth management firms and private banks identified and managed conflicts of interest that might arise when providing investment products manufactured within the same group/firm and put customer outcomes at risk.

Trust and confidence between the wealth management industry and their customers can be at risk if firms do not adequately manage their conflicts of interest. Without management of those risks, investment decisions can be made that result in unfavourable outcomes for customers, such as poor product selection and portfolio performance.

The review was based on a sample of 18 wealth management and private banking firms which had a total of £146 billion of retail customers' assets under management through discretionary and advisory services. They invested around 20% of this amount into investment products that were manufactured by a party connected to the firm.

1 Where reference is made to in-house investment products this relates to products manufactured within a firm or, where applicable, by a related entity within the same group as the firm. This definition can be extended to distributors of investment products with a commercial interest in a manufacturing firm, or where the manufacturer has a commercial interest in the distributor.

2 The FCA's approach to supervising wealth management and private banking firms, www.fca.org.uk/news/wealth-management-private-banking-approach

3 Business Plan 2014/15, www.fca.org.uk/static/documents/corporate/business-plan-2014-2015.pdf

4 Risk Outlook 2014, www.fca.org.uk/your-fca/documents/corporate/fca-risk-outlook-2014

Our work consisted of information requests to firms, desk-based analysis and firm visits. Our assessment focused on the use of IHPs in relation to business strategies and governance, identifying and managing conflicts of interest, management information, sales targets and remuneration, product selection (including product reviews and monitoring), and communications with customers.

Key findings and conclusions

Generally, the review found that firms recognised the potential risks from conflicts of interest to their customers, their reputation and market integrity.

We were pleased to observe that:

- there was a heightened focus by senior management within firms on conflicts of interest in relation to IHPs and they had taken steps to identify and manage weaknesses in their controls;
- we found no evidence of remuneration structures that could have biased investment decisions unfairly towards IHPs; and
- due diligence processes in selecting investment products and monitoring their subsequent performance appeared to be consistent between IHPs and third party products.

However, there were shortcomings and lack of consistency in several areas:

- firms did not articulate clearly enough how IHPs fitted within their business model and strategy, and were aligned with customers' interests;
- not all firms monitor the level of IHPs in customer portfolios, which could help to indicate how effectively they are managing conflicts; and
- communications with customers were not always clear about the nature of the firm's services and the extent to which IHPs might feature in customer portfolios.

It is important that firms which use IHPs remain aware of the inherent risk of conflicts arising from this business model, particularly when they seek to increase their assets under management and enhance profitability.

We shall be giving individual feedback to the firms that we looked at in detail and shall expect them to address any issues we raise with them. Other firms that were not involved in this review, which have access to IHPs, are expected to consider how their own arrangements meet the standards as set out in this report. The industry should keep under review the arrangements they have in place in in this area.

In view of the generally positive findings in this review, we are not proposing to undertake further thematic work within the wealth management and private banking sector on conflicts of interest in relation to IHPs.

2.
Scope of the thematic review

Background

Principles 8 and 9[5], and chapter 10 of the Senior Management Arrangements, Systems and Controls sourcebook (SYSC 10)[6] require a firm to manage fairly conflicts of interest between itself and its customers, and take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement. There is an inherent risk of a conflict of interest when investment firms invest retail customers' assets into IHPs. The conflict of interests between the investment firm and the customer arises because the investment firm effectively acts as agent for its customers when making discretionary investment decisions on their behalf or advising them to invest their assets into certain products. Therefore, it should be acting in the best interests of its customers.[7] At the same time, as commercial entities, firms will naturally seek to maximise their revenue and profits and this may conflict with their duty to their customers.

A firm is responsible for ensuring that its systems, controls and procedures are robust and adequate to identify and manage any conflicts that may arise and, as far as practicable, that those arrangements operate effectively. In practice, this responsibility rests with the firm's senior management, although the entire firm, from the board to frontline staff, has a part to play in ensuring that policies and procedures are implemented effectively.

What we did

Our review was based on a sample of 18 wealth managers and private banks, ranging from the largest global investment businesses to smaller UK investment firms. Some of the distributors were connected to asset management businesses that formed part of a wider global group structure while, in other cases, manufacturing and distribution were part of the same firm.

This review focused only on discretionary and advisory service offerings to retail customers. All firms were sent an initial high-level information request. A smaller sample was chosen for a more detailed request, after which we conducted desk-based reviews and visited a subset of firms. We engaged with both the Wealth Management Association and the British Bankers Association to obtain their views on our methodology and on the information we were seeking from firms. As a result of this constructive engagement, we were able to take on board industry comments (eg, on the content and timings of our data requests) and improve the quality of the information we received.

5 Principles for businesses, http://fshandbook.info/FS/html/FCA/PRIN/2/1
6 SYSC 10, http://fshandbook.info/FS/html/FCA/SYSC/10/1
7 COBS 2.1 Acting honestly, fairly and professionally, http://fshandbook.info/FS/html/FCA/COBS/2/1

During our firm visits, we engaged with all levels of staff, including chief executives, senior management, heads of risk and compliance, internal audit, product risk review teams, investment offices responsible for asset allocation and customer-facing relationship managers. This allowed us to gain a deep insight into how conflicts of interest relating to the use of IHPs were being identified and managed across the business.

We did not seek to assess the suitability of investments in individual customer portfolios, for example by reviewing customer files. We have already carried out extensive work on suitability in the wealth management sector and, while this clearly remains a key consideration in ensuring the fair treatment of customers, our focus was on the arrangements firms had in place to identify and manage conflicts of interest in the use of IHPs.

Who does this review affect?

The review is relevant to all firms that provide IHPs to retail customers through their discretionary and advisory services. This document is relevant to both the distributing entities and the manufacturing (asset management) entities.

It will be of interest to different parts of the business including boards, senior management, compliance, risk, heads of distribution and front office staff.

3. Findings

The areas we assessed were:

- business strategies and governance;
- identifying and managing conflicts of interest;
- management information;
- sales targets and remuneration;
- product selection, reviews and monitoring; and
- communications with customers.

Below, we have set out our observations and expectations and highlighted some examples of good and poor practice. Further examples can be found in Annex 2.

Business strategies and governance

Observation

Our review looked at the risks associated with the use of IHPs that arise from the business model of the firm (ie, activities that the firm is undertaking) and could result in potential or actual detriment to customers' interests or cause the firm not to act in the best interests of its customers. Almost all of the firms told us that the investment of retail customers' assets into IHPs did not form an explicit part of their business strategy. As a result, there is a risk that senior management may not have fully considered how the use of IHPs is aligned with their firm's overall strategy and customer interests.

Firms were however becoming increasingly aware of, and focused on, conflicts of interest in relation to IHPs. Some firms took proactive steps to review conflicts and got independent advice from consultants to identify and remedy shortfalls.

We found no agreements between manufacturers and distributors that required the latter to distribute a particular volume of IHPs to customers. This indicated that firms were not putting their own commercial interests above those of the customer in distributing IHPs to their customers.

Expectation

We expect firms to demonstrate that our principles and rules are embedded in their businesses and taken into account when considering conflicts of interest when using IHPs. It is part of senior management's responsibilities to ensure that the firm has robust systems and controls in place to identify and manage conflicts of interest that arise due to the firm's business model. Senior management responsibilities also include promoting a culture which supports the identification and management of conflicts of interest. Where firms make use of IHPs, they should be able to explain how this forms part of the business strategy.

The relationship between a distributor and an in-house manufacturer could potentially have a negative impact on customers' interests where there are commercial considerations that may override the fair treatment of customers.

Good practice

Some firms engaged third parties to report on the effectiveness of their conflicts of interest arrangements and identify any gaps.

Poor practice

Several firms, including some with high levels of assets under management invested in IHPs, were unable to explain how the use of IHPs was linked to their business strategy. There is a risk that these firms may not have fully considered how the use of IHPs was aligned with customers' interests, nor adopted a strategic approach to managing conflicts of interests in this area.

Detailed good and poor practice examples can be found in Annex 2 of this report.

Identifying and managing conflicts of interest

Observation

In almost all cases, firms were able to demonstrate that their compliance and risk functions had identified the potential conflict of interests that arise by offering IHPs alongside third-party products. All firms maintained a central risk log which recorded the conflict relating to the use of IHPs and any resulting mitigating actions. Firms had also established and maintained a conflicts of interest policy which set out the procedures and measures to manage conflicts of interest in the use of IHPs. We were encouraged to see that firms had recognised the conflict and had policies and practices in place to manage this conflict.

Expectation

Under SYSC 10, firms must take all reasonable steps to identify conflicts of interest.

Regardless of whether firms actually make use of IHPs or not, where they have access to IHPs this should be recorded as a potential or actual conflict of interest. Firms should record how they manage the conflict and review this periodically to ensure the information is kept up to date and the arrangements in place outlined in the policy are effective.

Good practice

Most of the firms had identified and recorded conflicts of interest that arose in relation to distributing IHPs as part of a conflicts matrix and register, and had mitigation plans in place.

Management information

Observation

We were concerned that some firms did not record the extent of their use of IHPs within management information, even when the volumes were significant. Senior management teams at most firms did not receive any management information about the overall level of investment in IHPs. There were indications that some firms had recognised the need to address this gap and to produce management information that will enable senior management to monitor the level of IHPs in customer portfolios going forward.

Expectation

Senior management, compliance and risk functions need to have clear information that informs them whether the potential conduct risks relating to the use of IHPs are being adequately managed and customers' interests are not being overridden by the firm's own interests. We expect firms to have in place systems and controls to manage risks to customer outcomes, for example by monitoring the level of IHPs in customer portfolios.

Poor practice

Several firms with high amounts invested in IHPs did not monitor the extent of use of IHPs in customer portfolios.

Sales targets and remuneration

Observation

Through our review, we did not identify examples of sales targets or remuneration structures that could have biased investment decisions towards IHPs and thus compromised the fair treatment of customers. Indeed, we saw several examples of good practice in this area.

Expectation

Remuneration schemes can incentivise individuals to place their own interests above those of their customers. For example, schemes which encourage bias towards products that are easier, quicker or more profitable to sell, but which may not be in customers' best interest, are likely to fall foul of our requirements. It may be difficult for a firm which creates strong financial incentives for its staff to promote certain IHPs over third party products to be able to manage the conflicts of interest and demonstrate compliance with SYSC 10.

Good practice

Remuneration structures within distribution channels, for example in the front office and portfolio construction units, appeared to be neutral towards investment in IHPs.

Product selection, reviews and monitoring

Observation

Due diligence processes appeared to be product-neutral, with similar rigour applied to the selection and subsequent reviews of IHPs and third party products. Our review explored the processes in relation to selection of investment products to understand whether firms had any undue bias toward the use of IHPs. Broadly, we saw the same level of due diligence on IHPs compared to third-party products, with most firms able to provide documentation to support this. There was evidence of firms putting IHPs, as well as third-party funds, on probation if issues such as performance were of concern and discontinuing the investment if there was no improvement.

In some instances, our review highlighted steps taken by manufacturing units to review whether their products continued to meet the intended target market. They collected information about the customers invested in IHPs, such as data on customers' risk profile and objectives. This allowed the manufacturers to gauge whether their products continued to meet the intended target market.

Expectation

Firms are expected to ensure they deliver their services as described to customers[8] and act in their best interests. Where a firm's service offering involves selecting investment products from a range, then it must do this in a way that reflects its duty to act in its customers' best interests.

Both distributors and manufacturers of IHPs have responsibilities to protect customers' best interests. Manufacturers should review whether investment products continue to meet the intended target market by collecting and analysing appropriate management information so that they can detect patterns in distribution compared with the planned target market, and assess the performance of the distribution channels through which products or services are being distributed. They should act when there are concerns, for example by ceasing to use a particular distribution channel.[9]

8 COBS2.2.1, http://fshandbook.info/FS/html/FCA/COBS/2/2 and COBS4.2.1, http://fshandbook.info/FS/html/FCA/COBS/4/2
9 RPPD, http://media.fshandbook.info/Handbook/RPPD_FCA_20130401.pdf

Good practice

Due diligence on product selection, reviews and monitoring appeared neutral between IHP and third-party products. There was evidence of firms terminating IHPs if the product failed to meet the defined criteria. One firm provided evidence of termination of an IHP within 24 hours of initial selection approval when one of the key components of the product had changed.

Communications with customers

Observation

Firms were generally clear about the relationship between the distributor and product manufacturer and, in some instances, clearly articulated their preference for using IHPs where possible. However, in reviewing customer communications in a number of firms, we found a lack of clarity in how firms disclosed the nature of the services they provided. We saw terms within customer communications which could be unclear or confusing. It was unclear whether firms had considered, when describing the nature of the services, if their customers were likely to understand the terms used.

Expectations

Principle 7[10] requires a firm to pay due regard to the information needs of its customers and communicate information to them in a way which is clear, fair and not misleading.

Poor practice

Terms were inconsistent and ambiguous with some firms stating they were 'restricted' but also that they were 'scanning the universe' for 'best of class' products.

While there was information about the relationship between the manufacturer and distributor, it was unclear whether customers would understand what the exact service offering was and the likely level of IHPs in portfolios.

10 Principle 7, http://fshandbook.info/FS/html/FCA/PRIN/2/1

4. Next steps

The review has not found evidence of any significant failure by wealth management and private banking firms to identify and manage conflicts of interest in their use of IHPs in retail customers' portfolios. As a result, we are not proposing to undertake any further thematic work across this sector on conflicts of interest in relation to IHPs, following this discovery work. However, we shall be giving individual feedback to the firms that we looked at in detail and shall expect them to address any issues we raise with them.

All firms that are using IHPs in providing retail discretionary and advisory investment management services may want to consider how their arrangements for identifying and managing conflicts of interest measure up against the examples of good and poor practice observed in the body of this report and Annex 2. Where firms identify shortcomings, we would expect them to take appropriate remedial action. We suggest that particular attention should be on articulating how the use of IHPs fits within the wider business strategy and aligns to customers' interests; having appropriate management information to monitor the use of IHPs; and ensuring that communications to customers are clear about the nature of the service offering and the proportion of IHPs that is likely to be in their portfolios.

Other related considerations

In this section we have highlighted further important areas for consideration in relation to IHPs, but which are not central to our main subject of our project. Firms should consider these further areas as relevant to their businesses and decide if any action is needed.

Transfers of business/outsourcing arrangements

Where a firm/group has used IHPs in customer investment portfolios and makes a decision to sell a manufacturing unit, which provided the products, to a third party, it should consider the impact on its customers. Where the firm/group wishes to outsource to the acquiring entity services that may impact the firm/group's customers, it must identify and manage any ongoing conflicts of interest that these arrangements may create, for example, in relation to performance-related incentives paid to the seller if post-sale conditions are met.

Prior to any outsourcing arrangement commencing, the firm must ensure that it manages the risks, including those to its customers, by satisfying the general outsourcing requirements set out in SYSC 8.1.[11] Firms should be able to demonstrate how customers' best interests have been considered. For example, any termination clauses should be sufficiently robust to protect the customer's interests and ensure that potential conflicts of interest from retaining customer assets with the acquiring entity have been identified and adequately managed.

11 SYSC 8.1 General outsourcing requirements, http://fshandbook.info/FS/html/FCA/SYSC/8/1

Best execution

We published a review in July 2014 on best execution and payment for order flow.[12] This document is relevant to all firms which execute, receive and transmit or place orders for execution, including portfolio managers. Many conclusions from that review may also be of interest to firms impacted by this paper on conflicts of interest from the use of IHPs, given their need to act in the best interests of their customers. For example, firms which rely on internalisation or on executing orders through connected parties should be able to evidence whether this delivers best execution and how they are managing potential conflicts of interest.

Financial incentives

We have carried out extensive work on the risks to consumers from financial incentives and the controls firms are using to mitigate risks. We published our most recent update in March 2014 on our website.[13] In this review of conflicts of interest in the use of IHPs, we did not discover any issues of concern relating to incentive schemes. However, firms may still wish to remind themselves of our broader findings on financial incentives, including the guidance that we issued in January 2013[14], particularly if they have not reviewed their incentive structures and associated controls from a conduct risk perspective recently.

12 TR14/13 Best execution and payment for order flow www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-13

13 TR14/4 Risks to customers from financial incentives – an update www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-04

14 www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg131

Annex 1
Relevant rules and guidance

Principle 2 (Skill, Care and Diligence)

Principle 3 (Management and Control)

Principle 6 (Customers' Interests)

Principle 7 (Communications with clients)

Principle 8 (Conflicts of Interest)

SYSC 8.1 (General outsourcing requirements)

SYSC 10 (Conflicts of interest)

SYSC 12.1.8R (General rule – Group risk systems and controls requirements)

SYSC 19A.3.9R (Remuneration Principle 3: Avoiding conflicts of interest)

COBS 2.1.1R (Client's best interests rule)

COBS 2.2.1R (Information disclosure before providing services)

COBS 2.3.1R (Rule on inducements)

COBS 4.2.1R (Fair, clear & not misleading communications)

COBS 6.1.4R & 6.1.6R (Information about a firm & its services)

COBS 6.1.9R (Information about costs & associated charges)

COBS 6.2A Describing advice services

COBS 8.1 Client agreements: designated investment business

COBS 16.1.1R (General client reporting requirement)

COBS 16.3.1R & 16.3.2R (Periodic reporting – provision by the firm and contents)

COBS 16 Annex 2R (Information to be included in a Periodic report)

Annex 2
Good and poor practice observed

This is a summary of the good and poor practice that we observed during the review. Firms that are using IHPs in providing retail discretionary and advisory investment management services may want to consider how their arrangements for identifying and managing conflicts of interest measure up against these examples.

Good practice	Poor practice
Business strategy / Governance/ Management information	
There was increased focus on conflicts of interest in use of IHPs. Firms had taken proactive steps to review their conflicts of interest and seek independent verification to identify gaps and remedy shortfalls including: • using management information to monitor the investment of customer assets in IHPs and associated potential risks; • appointing senior management to take responsibility for conflicts of interest; and • arranging for internal audit reviews.	Most firms were unable to articulate how the use of IHPs aligned to their business models and strategy. Firms did not generally record the use of IHPs in management information. This can inform the scale and extent of the conflicts and associated risks and give an indication as to whether controls are effective.
Product selection, due diligence and monitoring	
Similar levels of due diligence applied to IHPs and third party products, evidenced by supporting documentation. Our review showed manufacturers of IHPs had an approach to check that products were reaching the intended target market through the distributor at the customer on-boarding stage, which was updated and reviewed annually. We saw clear evidence of distributors discontinuing the use of products, including IHPs, and putting funds on probation, in response to underperformance against benchmarks. This was as a result of regular reviews of product performance. Redemptions of customer assets from in-house funds were driven purely by customers' interests and were not influenced by consideration of the impact such redemptions might have on the viability of the funds. Reverse enquiries: Firms were able to clearly demonstrate that customer-driven products, such as structured products, were executed on an unbiased pricing basis, even when the firm's own in-house manufacturer was approached in the process.	In one firm, we observed numerous committees with responsibility for due diligence on product selection, but there was ambiguity in overall responsibility for conflicts of interest in the use of IHPs. In another firm, we reviewed due diligence documents for investments across both internal and external mutual funds. While documentation for external funds recorded alternatives considered for investments, documents for internal mutual funds were largely silent on alternative options.

Identification of conflicts	
	We observed senior management failing to recognise staff with multiple roles, such as customer-facing, portfolio construction and fund management, as a conflict of interest. This can lead to firms failing to manage risks of conflicting roles to the detriment of customers.
Remuneration/Targets	
Remuneration structures within distribution channels appeared to be neutral towards investment into IHPs in front office and portfolio construction units. There were no specific targets for the sale of IHPs for distributors. Some firms had changed their remuneration structures to avoid any bias toward IHPs.	
Customer communications	
Customers were made aware of the relationship between the manufacturing division and wealth manager in customer-facing documents. One firm's discretionary service documentation stated clearly the potential conflict of interest: 'Where [we] act as the Investment Manager to a fund as well as Investment Manager of your discretionary portfolio there is a conflict of interest which must be managed. To ensure that we manage this conflict in your best interest, we perform an annual review of all related funds and will subsequently send you an annual confirmation (where appropriate) that such funds are still suitable to be held within your discretionary portfolio.' Some firms advised its customers that it had a preference for using its own products except when it lacked coverage for certain asset classes. This was evidence of transparency about overall potential assets under management that may be invested in IHPs. One firm said that it intended to amend its periodic statements to disclose the level of IHPs held in portfolios in the form of a pie chart, to make it clearer to customers.	Service descriptions in customer documentation can be opaque and confusing. One firm used terms such as 'open architecture', describing the service as being 'restricted' and one which 'scans the universe'. These potentially contradictory terms may lead to customers not having a clear understanding of what service they have agreed to. There was potentially misleading language when firms were heavy users of IHPs but their customer documentation stated 'we may use some in-house funds' and 'we can select fund managers from the widest possible range of expert managers...funds within the portfolios are selected from the market and may include funds managed by us'. These statements may understate the extent to which IHPs may be used. Periodic statements did not always clearly identify investments that were IHPs. In particular, the use of certain proprietary names for IHPs may have made it difficult for customers to understand the extent of investment in IHPs.

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