

MACFARLANES

**INDUCEMENTS: WHAT CAN PROVIDERS DO?
A BRIEF RECAP OF THE LEGAL POSITION**

PAUL ELLISON, PARTNER

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OVERVIEW

- **Finalised Guidance from FCA in January 2014 on retail investment advice**
- **Follows on from the Retail Distribution Review (RDR)**
 - Aimed to limit the impact that adviser remuneration has on the research provided to retail clients
- **Providers of investment products ('providers') no longer able to make commission payments to advisory firms**
- **Attempt to encourage competition between providers based on the quality and price of their products**
- **Aims to remove the conflict of interest inherent in the structure**

CONFLICTS

- **Principle 8 of the FCA Rules requires that:**

A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client

- **SYSC 10 expands upon Principle 8**

- Firms required to identify, record and manage conflicts
- Disclosure obligation (SYSC 10.1.8R)

- **FCA has clarified ‘expectations’:**

- Concerned about potential and actual conflicts – any payments or benefits to advisory firms give rise to the risk of conflicts by incentivising a firm to act otherwise than in its customers’ best interests
- Clear statement that there are some situations where the only effective way to protect clients’ interests is for agreements to be terminated or not entered into

COBS 2.3 – THE INDUCEMENT RULES

- **COBS inducement rules aim to prevent any activity that is not in the clients' best interests**
- **Reimbursement of costs:**
 - Payments from providers to advisory firms should not exceed a reimbursement of the costs incurred by the advisory firm
- **Hospitality and gifts:**
 - Must be of 'a reasonable value' and must enhance the quality of the service provided to the client
 - Reasonable value test:
 - Located in the UK
 - Designed for business purposes e.g. product training
 - Etc.

COBS 2.3 – THE INDUCEMENT RULES

- **Meetings between providers and advisory firms:**
 - Payments for commercial meetings from providers to advisory firms are prohibited by the inducement rules as other providers who are not willing to pay may be put at a disadvantage
- **Management information (MI), data, and research services:**
 - The purchaser of this information must be able to show that it results in an improvement in the quality of the service to clients
- **Conferences and seminars:**
 - COBS 2.3.15G ‘provider may ... pay towards cost of the seminar if its participation is for a genuine business purpose’
 - Payment must be reasonable
- **COBS 2.3.15G gives guidance on what benefits are capable of enhancing the quality of the service for the client without breaching the inducements rules**

PRINCIPLE 3 – SYSTEMS AND CONTROLS

- **Principle 3 of the FCA Rules requires that:**

A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems

- **Expanded upon in SYSC**

- Must take reasonable care to establish and maintain systems relevant to firm's business (SYSC 3.1.1R)
- Establish implement and maintain adequate policies and procedures sufficient to ensure compliance with regulation

- **Good practice examples given by the FCA:**

- Detailed analysis by providers of services offered by advisory firms
- Clear internal policies on distributor spending within providers
- Controls within advisory firms to ensure recommendations not impacted by providers

SOME PRACTICAL CONSEQUENCES

- **Panel selection**
- **Training**
- **Hospitality and gifts**
- **IT development and maintenance**
- **“Promotional activity”**
- **Outsourced services**

THE INTERNATIONAL PERSPECTIVE - THE EU (1)

- **Position at EU level generally (under MiFID) is that firms must:**
 - Take all reasonable steps to identify conflicts of interest
 - Disclose the general nature and source of any unavoidable conflicts of interest to clients before conducting business with them
 - Establish conflict of interest policies setting out any conflicts of interest and how they are to be managed
- **Most EU member states have similar requirements to each other, with some variation**
- **MiFID II will bring in various changes (including a ban on inducements in certain circumstances) and will essentially harmonise the position across all EU member states**
- **Netherlands:**
 - Already introduced a ban on inducements for investment firms: effective 1 January 2014 (by amending the Market Conduct Supervision Decree)

THE INTERNATIONAL PERSPECTIVE – THE EU (2)

- **France:**
 - Market practice for investment service providers to receive a rebate or inducement from the issuer of the financial instrument instead of a fee from the client: this must be disclosed to the client (Article 314-76, General Regulation – Book III)
- **Germany:**
 - Fee-Based Investment Advice Act recently introduced various rules for fee-based advisers. Commission may only be received from third parties if it is immediately passed on to the client to avoid any conflicts of interest
- **Ireland:**
 - A firm must ensure its officers or employees do not offer, give, solicit or accept any gifts or rewards likely to conflict with any duties of the recipient in relation to his or her activities in the firm, or to the firm itself (3.35, Consumer Protection Code)

THE INTERNATIONAL PERSPECTIVE – THE USA (1)

- **Broker-dealer:**
 - General requirements:
 - Securities Exchange Act 1934 – prohibits use of manipulative practices when entering into sale/purchase of securities
 - Management of conflicts of interest:
 - FINRA Rule 5320 – prohibits firms from trading ahead of a customer order when trading on firms own account
 - Disclosure:
 - FINRA Rule 2262 – where broker-dealer has relationship with issuer of the relevant securities the relationship must be disclosed
 - Inducements:
 - NASD Rule 2830(k) – prohibits firms from favouring sale of a fund because of brokerage business that has or may be directed to the firm

THE INTERNATIONAL PERSPECTIVE – THE USA (2)

- **Investment advisers – principles-based regulatory regime.**
 - Investment Advisers Act 1940:
 - Investment adviser is deemed a fiduciary
 - It owes fiduciary duties to its clients. As part of these duties an adviser is required to fully disclose all material information to the client in an attempt to eliminate all conflicts of interest

THE INTERNATIONAL PERSPECTIVE – HONG KONG AND SINGAPORE

- **Hong Kong**

- Similar provisions relating to analysts' research on shares issued on the Hong Kong Stock Exchange contained in the Securities and Futures Commission Code of Conduct
- Requirement to establish policies and control procedures for avoiding and managing conflicts of interest
- Requirement to make clear and prominent disclosures of certain conflicts in any research published (e.g. the “outside influence” of the issuer)

- **Singapore**

- Requirement to have in place procedures to eliminate or manage undue influence of issuers
- Financial Advisory Independent Review (FAIR) parallel to the RDR
- Focus on improving the quality of advisors and fairness in the industry

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PAUL ELLISON, PARTNER

Macfarlanes LLP 20 Cursitor Street London EC4A 1LT
T +44 (0)20 7831 9222 F +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com

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