Guidance consultation

Proposed update to the distributor-influenced funds factsheets

December 2011

The following pages show the changes to our documents. Responses should be returned by 30 January 2012 (8 weeks) to jason.pope@fsa.gov.uk.

Points for distributors to consider

This factsheet is for distributors with their own range of distributor-influenced funds or that are planning to introduce one. It may also be of interest to:

- firms that run or help to run distributor-influenced funds for distributors; and
- product providers and platforms that include fund links to distributor-influenced funds.

It explains:

- what we mean when we refer to distributor-influenced funds; and
- what to consider when adopting and using distributor-influenced funds.

The factsheet reflects our current rules and has been updated to explain our expectations as a result of rule changes in the Retail Distribution Review.

Deleted: Information is based on current regulation, which may change following consultation on proposals in the Retail Distribution Review Feedback Statement 08/6.

There are no rules which relate specifically to distributor-influenced funds: the factsheet provides guidance on rules which have a more general application. Some of the observations we make in this factsheet will therefore also be relevant to other investments.

What are distributor-influenced funds?

Distributor-influenced funds are created for the clients of a particular distributor, typically an adviser firm. They could be designed on a bespoke basis for the distributor or they could be set up using an existing fund that is tailored for the distributor. Fund administration and management is outsourced to other firms but the distributor may have a degree of influence over the fund (short of day-to-day asset selection). It may be, for example, that the distributor is able to:

- influence the hiring (or removal) of the Authorised Corporate Director or the delegated investment manager; or
- create accountability of the investment adviser by attending investment committees.

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Deleted: <#>appoint (or remove) the Authorised Corporate Director.¶

They are commonly arranged as open-ended investment companies (OEICs) (where they may be known as broker OEICs, distributor funds or distributor-owned funds) but may also take other structures (like insurance funds). We have chosen to refer to them as distributor-influenced funds in this factsheet, as this term covers the full range of possible structures.

In this factsheet, distributor-influenced funds are distinct from the operations of fund managers, collective investment scheme operators and private client investment managers for whom investment management is central to the business proposition. They are arranged by firms that have chosen to outsource to professionals as their preferred route, potentially without permission to manage investments or operate a fund.

Our key concerns

If you are recommending these funds, you must ensure they are suitable for each client and do not simply increase complexity and costs. Given the potential for conflicts of interest to arise and the other issues detailed in this factsheet, we expect you to put in place robust systems and controls to ensure that the use of these products is in the best interests of each client.

Our principal concerns are that you should:

- employ staff who are competent to work with these products;
- manage conflicts of interest effectively;
- ensure that the product is suitable for each client to whom it is recommended; and
- analyse the impact of charges and disclose this to clients.

The rest of this factsheet discusses how these, and other, issues may be addressed in practice.

Training and competence

Greater involvement in the way the fund is run will have training and competence implications for your firm, advisers and other staff (especially those working with the fund managers to decide the appropriate asset allocation and strategy). In particular, you need to make sure that relevant staff understand:

- asset allocation and portfolio construction;
- the distributor-influenced fund proposition and its implications for consumers;
- the implications for and inter-relationships with the client's other holdings in their existing portfolio;
- whether there is a need to revisit advice on a regular basis; and
- any conflicts of interest that arise and how they are mitigated and disclosed.

In addition, if you go further and decide to take on even greater responsibility by acting as the fund manager, this may have further implications. Changing asset allocation and investment decisions without a client's express consent will require FSA permission for managing investments or to act as a broker fund adviser if you are managing a broker fund. Staff will need to be suitably qualified in investment management and a client agreement will be needed giving you discretion to act.

Questions to consider

1. Have you considered the nature of your activities regarding any distributor-influenced funds, including whether you are managing investments and therefore need to vary your scope of permission?

2. What training needs have you identified in relation to the use of distributor-influenced funds?

3. How will you address the training needs?

4. How will you measure the success of the training provided?

5. How will you assess competence on an ongoing basis?

Conflicts of interest

Distributor-influenced funds can create conflicts of interest (between your firm and your advisers or your advisers and their clients) that you need to manage appropriately. For example, a firm's desire to make an administrative cost saving or to increase the firm's acquisition value should not lead to customers being recommended a distributor-influenced fund when this will not be in their interests. You must manage any potential conflicts of interest.

Questions to consider

1. How is your firm's role in the fund disclosed to the client?

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2. If, when an adviser retires, your firm offers to 'buy' back his or her clients, do holdings in distributor-influenced funds add substantially to the value offered?

3. Similarly, if your firm's overall buyout value is increased substantially by holdings in these funds, does this lead to a conflict of interest for advisers?

4. What steps have you taken to identify other conflicts of interest?

5. Do advisers receive additional incentives (such as shares in the firm, additional entitlement to a bonus or a free holiday/ training sessions held abroad for top producers) to recommend your firm's distributor-influenced fund rather than an alternative fund?

6. How are these conflicts of interest managed and disclosed to the client?

Adviser charging

The Retail Distribution Review requires all adviser firms to set their own charges. This will mean that from 31 December 2012:

- firms advising on distributor-influenced funds should no longer receive a share of the annual management charge for their role on a distributor-influenced fund governance committee; and

- adviser charges for recommending a distributor-influenced fund should not vary inappropriately compared to substitutable or competing retail investment products.

Independence

If you wish to call yourself independent, you must currently provide advice on packaged products from the whole of the market and offer customers the option to pay by fee.

Deleted: If you are calling yourself independent and are using a distributor-influenced fund, access to the fund on some products should not distort this requirement and the need to give suitable advice to all clients. (As part of the Retail Distribution Review, we will be consulting on changes to our rules to make the standards expected of independent advisers clearer and widening them to cover investments other than packaged products.)

The Retail Distribution Review will make changes to the standards expected of independent advisers. From 31 December 2012, firms holding themselves out as independent must only make personal recommendations based on a comprehensive and fair analysis of the relevant market that is unbiased and unrestricted.

Where firms holding themselves out as independent want to recommend a product offered by a connected firm, like a distributor-influenced fund, we would expect to see evidence for each recommendation that the advice is:

- suitable;
- made following a comprehensive and fair analysis of the relevant market in an unbiased and unrestricted manner;
- in the customer's best interests; and
- in accordance with conflicts of interest requirements.

Given the inherent conflicts of interest involved, we would question whether an independent firm could meet its obligations to act in the best interests of its client and provide advice in an unbiased manner if it recommends a distributor-influenced fund.

Questions to consider
1. What steps have you taken to ensure you continue to meet the requirements to call yourself independent?

Suitability

The specific features of a distributor-influenced fund may make it suitable for some clients. However, this will not be the case for all of your clients. The suitability of any fund will depend upon the client's particular circumstances and requirements. Irrespective of your firm's strategic decision to use distributor-influenced funds, you must still act in each client's best interests and consider the suitability of the fund, its asset allocation, strategy and structure for each client before recommending it (or recommending a switch into it within an existing product).

You must rigorously assess which product is suitable for each client and record the reasons for your decisions. You cannot assume that a particular product will be the best choice in all cases.

Questions to consider

1. How have you decided that a distributor-influenced fund is suitable for the client compared with other substitutable products?

2. Is the way in which the fund is managed and the basis on which asset allocation has been decided suitable for the individual client?

3. Does the product structure through which the fund is accessed (an investment bond or pension, say) have a significant impact? In assessing the impact of this, you may want to consider the extent to which the reduction in yield for the final product is higher than for other funds and products available in the whole market. Advantages such as tax benefits available through particular product structures may not be sufficient to balance these additional costs.

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4. How will you assess whether the total impact of higher charges on expected returns is acceptable compared with other funds on the market? There may be a reduction in yield above which you no longer expect this product to be suitable. This may be the case particularly for lower risk strategies where lower, more stable returns are targeted and higher charges would have a greater impact.

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5. If the client has other assets, will the distributor-influenced fund's standardised asset allocation be suitable for them or will it unbalance their overall portfolio?

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6. How do you take into account other factors beyond attitude to risk and existing assets (like investment term or the need for income) in recommending investments?

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7. Distributor-influenced fund structures that allow underlying investments to be traded within the fund and thus avoid attracting a potential capital gains tax (CGT) liability may not be effective tax planning for all clients. This is often cited as a reason to recommend a distributor-influenced fund instead of an independent fund but many clients would benefit from making some use of their annual CGT allowance each year rather than building up a liability over time within a distributor-influenced fund. Is the distributor-influenced fund a CGT-efficient investment for the individual client?

8. Where a client's existing investment does not allow access to a distributor-influenced fund (especially where the current investment includes a wide range of fund links), is this sufficient reason to rebroke business to a platform or product that does include the link? If so, how will you demonstrate that the benefits of the fund outweigh the costs of moving?

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9. Tied advisers currently, and restricted advisers under the Retail Distribution Review, should consider how the inclusion of a distributor-influenced fund in their product range will affect the suitability of advice. If the product range is limited only to distributor-influenced funds, what advice is provided if those funds are unsuitable for a client?

Communications with clients

When using distributor-influenced funds you need to communicate information in a way that is fair, clear and not misleading. This applies both to verbal and written communications and may include the following:

- documenting why your recommendations for distributor-influenced funds were suitable;
- disclosing all sources of remuneration and inducements, including any share of fund charges paid to you;
- communicating the overall effect of charges including the cost of the fund, of the product in which it is held (if relevant), the costs for paying adviser remuneration and the likely costs of the underlying investment funds held within a multi-manager distributor-influenced fund;
- disclosing conflicts of interest;
- explaining ongoing reviews, you should make it clear to your clients what services you are providing on an ongoing basis and whether this is generic (e.g. monitoring of the distributor-influenced fund) or personal (e.g. whether the fund is still suitable for the clients);
- explaining the features, advantages and disadvantages of the distributor-influenced fund; and
- explaining the issues for non-advised sales or default funds, given the complexity of issues described in this factsheet and the potential for conflicts of interest to arise, we consider that it is unlikely to be fair to use non-advised sales methods or for distributor-influenced funds to be offered as default funds. If they are to be made available in this way, you should consider how best to communicate the additional risks and features of the product.

Question to consider

1. How do you ensure that your communications in relation to distributor-influenced funds meet the information needs of your clients and that they are fair, clear and not misleading?

Management and control

You may also want to make changes to your business processes to help manage the challenges of offering distributor-influenced funds. For example:

- ensuring that business activities are within your permitted regulatory activities;
- assessing commercial viability: before launching a new fund, you should assess whether it will be commercially viable based on realistic assumptions and without compromising your obligation to provide suitable advice to each client (a contingency plan is needed in case funds do not achieve commercial viability);

Deleted: 8. If an adviser proposes to take trail commission for ongoing servicing, is this justified? What does the commission pay for and how will you ensure that the client receives that additional service? It is unlikely to be fair to take trail commission if this acts as an additional charge only paying for asset allocation servicing that is undertaken centrally and paid for from a share of the annual management charge.¶

- characterising the target market: you will also need a process to identify the key client profiles to be served. It is very unlikely that a fund could be suitable for every client with the same risk profile as they will have other needs to be addressed;

- assessing and adopting new systems: you may need to work with the provider and fund manager to consider the fund strategy and asset allocation, which tools to use and how to monitor the fund and make changes in the future;

- assessing the impact of charges: a key issue to consider is the impact of charges on performance and whether the charges (particularly when the fund is added as a link in another product) will reduce the expected return significantly compared with other funds on the market, undermining the benefit of this investment; and

- deciding whether to allow non-advised distribution methods or the use of distributor-influenced funds as default funds: as discussed above, we consider that it is unlikely to be fair to use non-advised sales methods for distributor-influenced funds or for them to be used as default funds. If, however, you wish to do so, you need to pay particular attention to how this could be done in an acceptable manner.

Deleted: <#>deciding the status of trail commission: as noted above, it is unlikely to be fair for trail commission to be taken in order to pay for ongoing asset allocation servicing, if asset allocation is updated centrally for all customers (which implies a more limited role for the client's adviser); and ¶

We note that many advisers are involved in choosing the default fund from an existing range for group personal pension plans. We do not regard this as falling within the scope of this factsheet.

Questions to consider
1. How will you manage the launch of distributor-influenced funds?
2. Is the plan to achieve commercial viability realistic?
3. What will happen if the fund does not reach commercial viability?
4. How have you segmented your client base and decided the risk profile of the funds you offer?
5. How will you monitor these decisions and review asset allocation decisions?
6. What regular assessments will you make of use of the product and your systems and controls in relation to it?

Points for Authorised Corporate Directors, fund managers and platform providers to consider

This factsheet is for:

- firms that run or help to run, distributor-influenced funds for distributors;
- product providers and platforms that include fund links to distributor-influenced funds; and
- firms that are considering any of these activities.

It may also be of interest to distributors with their own range of distributor-influenced funds or that are planning to introduce one.

It explains:

- what we mean when we refer to distributor-influenced funds; and
- what to consider when using distributor-influenced funds.

The factsheet reflects our current rules and has been updated to explain our expectations as a result of rule changes in the Retail Distribution Review.

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What are distributor-influenced funds?

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- influence the hiring (or removal) of the Authorised Corporate Director (ACD) or the delegated investment manager; or
- create accountability of the investment adviser by attending investment committees.

Deleted: ; or
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They are commonly arranged as OEICs (where they may be known as broker OEICs, distributor funds or distributor-owned funds) but may also take other structures (like insurance funds). We have chosen to refer to them as 'distributor-influenced funds' in this factsheet, as this term covers the full range of possible structures.

In this factsheet, distributor-influenced funds are distinct from the operations of fund managers, collective investment scheme operators and private client investment managers for whom investment management is central to the business proposition. They are arranged by firms that have chosen to outsource to professionals as their preferred route, potentially without permission to manage investments or operate a fund.

Our key concerns

If you are to use these funds, they should not simply increase complexity and costs without providing new services and good value for money for clients. Although the distributor has most responsibility for the way the product is sold to the end-customer, all parties involved in the product have a share in the responsibility to treat those customers fairly. If you run the funds or make them available through other products you should consider how your actions help distributors to act fairly for the end client. More information on the respective responsibilities of providers and distributors is available in the Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD).

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You should take into account that many distributors entering this market may not have practical experience in it and that the product presents different risks to those to which the distributor and its customers are ordinarily exposed.

Issues to consider

You may want to review your business processes to help distributors manage the challenges of offering these funds. It remains your responsibility to identify the issues that will be relevant but the following are some areas that you will want to consider.

- Marketing the proposal to distributors: promotional material to distributors should present a balanced view of the product, including the risks of the product and its disadvantages, to help advisers assess suitability for their clients. The fund prospectus, for which the ACD is responsible, should set out the relationship between the various parties, the extent of the distributor's decision-making powers, and the charging arrangements if payments are made out of scheme property.

- Assessing commercial viability: before launching a new fund, you should assess whether it will be commercially viable based on realistic assumptions and without compromising the adviser's obligation to provide suitable advice to each client (a contingency plan is needed in case funds do not achieve commercial viability).

- Due diligence: a related matter is your assessment of whether to work with a particular distributor at the outset and regularly reviewing this decision (considering, for example, areas such as their training and competence, conflicts of interest procedures and TCF programme).

- The appropriate level of distributor influence: it is important to decide the appropriate level of influence that you will accept from the distributor and to keep a clear distinction between the regulated activities each party is expected to perform. This is especially important if you are the fund's ACD because you have the ultimate regulatory responsibility for operating it compliantly, regardless of your commercial relationship with the distributor.

- Product design and market research: where relevant, you should consider work done to identify the target market and its needs, and whether the fund's charges are appropriate for expected returns (particularly for lower risk strategies where lower, more stable returns are targeted and higher charges would have a greater impact). There may be a reduction in yield (for products) or total expense ratio (for funds) above which you no longer expect this product to be suitable.

- Communications with clients: it may be that you are better placed to produce standardised product disclosure material than distributors who are not normally required to produce this information.

- Non-advised sales: given the complexity and potentially high costs of these funds, it is unlikely to be fair to allow non-advised sales methods of distributor-influenced funds. Where relevant, if you wish to allow non-advised sales methods, you need to consider how this could be done in an acceptable manner.

- Default funds: for similar reasons, it is unlikely to be fair to allow distributor-influenced funds to be sold as default funds. Where relevant, if you wish to allow them to be used as default funds, you need to consider how this could be done in an acceptable manner.

We note that many advisers are involved in choosing the default fund from an existing range for group personal pension plans. We do not regard this as falling within the scope of this factsheet.

Questions to consider
1. How will you promote distributor-influenced funds to distributors?
2. What due diligence will you conduct?
3. How will you assess how the design of the product meets the needs of the end client?
4. Will you allow non-advised sales or the funds to be used as the default option on a product?
5. What will happen if the fund does not reach commercial viability within an acceptable period?
6. How will you monitor funds to assess whether changes are necessary or whether different parties are performing the regulated activities for which they are responsible?
7. How will you assess whether the impact of higher charges on expected returns is acceptable?

Changes as a result of the Retail Distribution Review

From 31 December 2012, firms advising on distributor-influenced funds will not be able to receive a share of product charges as remuneration. This means that you cannot pay a share of the annual management charge to them for their role on a fund governance committee.

Deleted: **Further changes proposed in our Retail Distribution Review ¶**
Next year, we will be consulting on changes to our rules to require all adviser firms to set their own charges. Under these new proposals, advisers would not be able to agree a share of product charges with you: instead, they would have to make the case to their customers if they wanted to charge them higher sums compared to charges for equivalent services involving other products. For more information on our Adviser Charging proposals, see Feedback Statement 08/6: Retail Distribution Review. ¶