

Managing conflicts of interest

CII RDR Position Paper 4

Retail Distribution Review

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The CII is the world's leading professional organisation for insurance and financial services. It maintains the professional, ethical and technical standards of the industry.

The CII works with corporate business to develop organisation wide solutions for ensuring ongoing competitive advantage through technical and professional competence of employees at every level.

Individually, qualified CII members commit to Continuous Professional Development (CPD) through enhancing their knowledge to maintain their professional standing. Its 90,000 members in 150 countries make up the largest professional body in the financial world.

As a society, we all rely on professionals to maintain accurate and relevant knowledge and to give appropriate and unprejudiced advice. The CII ensures that we can trust in the competence and conduct of insurance and financial services professionals the world over.

The knowledge, and how

Foreword

by Rt. Hon The Lord Hunt of Wirral, President of the CII

Conflicts of interest occur all the time and in all spheres of economic activity; retail financial services is not exempt. These are potentially “grey” areas that, if not identified and managed, can waste money and act as catalysts for scandals that ruin institutions’ reputations and weaken consumers’ trust in the financial services system as a whole.

Conflicts of interest cannot be managed by a simple set of rules. For similar reasons, the FSA has recognised that a rule-book (however voluminous) cannot cover every situation and is now pursuing a strategy of regulation through a principles-based approach. It recognises that markets do not stand still, nor do ways of operating in business, so any new or revised rules-based regime will soon become out of date.

In the same way, conflicts of interest can arise in many forms and guises; they often arise in situations that are not conveniently clear-cut. They can involve questions of degree, which in turn require the application of considerable knowledge and judgement to assess. In particular, they thrive under conditions where individuals are unclear about the standards of conduct and behaviour that are acceptable.

The Chartered Insurance Institute has long recognised that this is an area of complexity, but also of importance to the industry. Its own code of ethics requires members to identify and avoid conflicts of interest – but the key word here is “**members**” – a body of people that is largely self-selecting and has agreed to be bound by the code. The CII has also made strong efforts to ensure that its own code of ethics is clear and well communicated.

Where there are those operating outside the requirements of a professional body, there is a public interest argument for market rules that require conflicts to be minimised – hence the FSA’s Retail Distribution Review, that is grappling with these very questions. This paper sets out some thoughts which we hope will contribute to the shape of reform. I do accept that the way the CII approaches the management of conflicts of interest is not the only one; it is but one contribution to a debate with significant implications for our industry. Nevertheless, I hope it will give the industry some thoughts on enshrining the management of conflicts of interest properly in a professional code of conduct.



1. Summary

Much of the debate over the RDR has focused on the contentious issue of commission. As a professional body we believe this is an issue to be debated by the industry but it has two aspects: distribution strategy, which is primarily a matter for product providers, and professional practice issues, which are primarily a matter for professional bodies and their members. This paper addresses the latter and starts from the principle that professionalism means transparency in all dealings.

We recommend in this paper that:

- In parallel with the work arising from the RDR on the issue of commission, a professional approach to the identification and management of conflicts of interest should also be considered;
- A professional approach should consist of a ‘conflicts code’ and guidance to both firms and individuals;
- A key principle of this professional approach is transparency;
- The approach to conflicts adopted by the CII (described in this paper) could be used as an example to aid discussion at this stage;
- The separate suggestions in the CII first position paper, and a future paper on the professional body structure, would create a professional framework for retail financial services within which a conflicts policy could be communicated and enforced;
- The independent single professional standards board, which we suggested in our first position paper, should address the issue of conflicts of interest as a priority;
- A professional body (or bodies), in this work, should take account of the law of agency, and address the question the duties owed by advisers to their clients.

We believe that the issue of conflicts of interest and how they are managed is central to any discussion of the future of retail financial services. The CII believes it has a strong role to play in helping the industry deliver the step change needed to convince regulators, policy makers and consumers that conflicts in the industry have been identified and that they are being managed appropriately.

2. Why is there a problem?

The conduct of business regulatory regime for financial services aims to deal with practices and behaviours in the market which result in consumers receiving inappropriate advice and as a result suffering financial loss. Successive regulators have appeared to make the assumption that the traditional reward structure for selling financial products has biased the behaviour of advisers when recommending those products to consumers. It is further assumed that consumers exert weak market power because they lack the information and knowledge in the products to challenge the sales person.

This mis-match between consumer needs (for good advice and reliable products) and industry objectives (to achieve distribution and profitability), and what can be done about it that would be effective, has run as a constant theme through regulatory policy discussions since the Financial Services Act 1986 and is now a key issue in the FSA's Retail Distribution Review.

Whilst it is less easy to provide definitive evidence to substantiate these assumptions which would conclusively indict the industry, there is now a general consensus around the RDR debate that trust and confidence will only be improved if the industry is seen to be addressing them.

Economists assume a reasonable balance of information exists between sellers and buyers to ensure that trades take place at prices which reflect the intrinsic worth of the good or service in the prevailing conditions. When that happens, the price adjusts to the point where the supplier makes a profit (but not an unreasonable one) the distributor makes a profit (again, not an excessive one) and the consumer gets value for money. At least, that is the theory. But this theory does not describe well consumers' experience of retail financial services.

A number of factors may be in play:

- i) the industry makes products that are difficult for consumers to understand;
- ii) the products are intangible; they cannot be 'inspected' or subjected to a 'fit for purpose' test in the same way as a car or a television, so a buyer cannot easily form a view of them;
- iii) the products call for the buyer to defer consumption; obviously, if they are a form of saving rather than just insurance, the expectation is that consumers will enjoy greater purchasing power at some later time but a number of factors can lower expectations of the reality of this outcome, not only at the time of purchase but over the life of the product;
- iv) the promises of providers and advisers may not be believed and, more seriously, the financial system may not be trusted;
- v) product providers view distributors rather than consumers as their customers and therefore have insufficient regard for the customer experience, regarding customer care as a matter for advisers, whilst advisers may have insufficient knowledge to ensure consumers are fully apprised of the risks and rewards of the courses of action recommended to them.

However, many markets have the characteristic that more information is held by one party than another. Typically, suppliers hold much information and consumers very little. In some markets these differences do not matter. The workings of an internal combustion engine are known to the car manufacturer but no detriment arises to consumers who do not understand how engines work compared with those who do. For simple financial services products this position may also hold good.

2. Why is there a problem?

But where consumers' lack of information is combined with promotion by the industry of an intangible product whose characteristics are not easily understood and may change in response to the movements of financial markets, and, crucially, where potential risks are not properly highlighted by appropriate warnings or advice, the phenomenon which we have dubbed 'mis-selling' may arise.

The regulatory regime has tried to overcome these potential, and sometimes actual, failings by encouraging transparency of products, by emphasising the need for suitable advice and, in some cases, by specifying risk warnings. A variety of product, charges and expenses and commission disclosure devices has been tried over the years to help consumers understand the nature of products and the possible incentives to which those who sell them may be reacting.

However, it is clear from the review of prudential rules in the FSA's Discussion Paper 07/4, which highlights the undesirably high level of claims presented to the Financial Ombudsman Service and to the Financial Services Compensation Scheme, that additional measures are needed to raise the level of performance of the industry and encourage public confidence.

It is our belief that solutions to the problems of mis-selling which rely on consumers exhibiting significantly greater awareness of their needs or of the key characteristics of products offered to them are, for the foreseeable future at least, flawed. What the financial services industry should do is to make sure that consumers who use our services are treated with respect and are not encouraged to take decisions to invest by untrue or misleading promises or advice and that proposals made to them are not affected to their detriment by concealed and conflicted motivation.

Transparency is vitally important and we would not downplay the alternative approaches to intermediary remuneration discussed in the RDR Discussion Paper, but we believe that the time has come for new thinking - going beyond the requirements of the regulatory conduct of business regime, to place much more emphasis on professional standards which identify, manage and mitigate conflicts of interest. Furthermore, these standards might be powerful if applied in the context of a professional body, where peer pressure can be exerted.

We come back to the way this work could be carried forward in later paragraphs. But first, to provide context, we set out in the following paragraphs an outline of a conflicts policy.

3. A professional approach – the CII Code

The CII's position on conflicts has been documented in its Code of Ethics and Conduct and in supplementary guidance, summarised below.

The Code states that members should:

- Avoid conflict between personal interests, or the interests of any associated company, person or group of persons, and duties to customers;
- Avoid conflict between any competing interests of one or more customers, stepping aside if such conflicts cannot be resolved;
- Avoid conflict between personal interests, or the interests of any associated company or person, and duties to their employer.

Members of the CII are also obliged by the Code to comply with all relevant laws, including the requirements of any regulatory authorities. In the UK the high level regulatory obligation in respect of conflicts of interest is set out in FSA's General Principle 8 which requires a firm 'To manage conflicts of interest fairly, both between itself and its customers and between a customer and another client'.

4. What is a conflict of interest?

The term ‘conflict of interest’, means any financial or other interest which conflicts with the duties an individual owes to a person to whom he or she is providing services.

‘Conflict of interest’ means something more than individual bias. There must usually be an interest (often financial) which could directly influence the service provider.

‘Conflict of interest’ applies only to current interests. It does not apply to interests which have expired, no longer exist and cannot reasonably affect current behaviour. Nor does it apply to possible interests that may arise in the future but do not currently exist because such future interests are speculative. For example, a pending formal or informal application for a particular job or contract is a current interest but the mere possibility that one might apply for such a job in the future is not.

‘Conflict of interest’ applies not only to the interests of the individual service provider but also to the interest of others with whom that individual has substantial and common interests, if these interests are relevant to the functions to be performed, e.g. their employer, business partners, family members and any one else with whom they have a substantial common interest.

5. What the Code means for firms

Firms should be able to demonstrate they have rigorous internal policies in place and procedures for identifying and managing conflicts of interest to avoid adversely affecting their customers. A list should be drawn up of the situations across the business where the duties individuals owe to their clients may be inconsistent with either their own interests or the interests of one or more clients.

Having identified a list of potential conflict situations, appropriate systems need to be in place to manage them and employees trained in their use. These procedures need to be regularly tested and updated, where appropriate.

Conflict of interest requirements should be objective standards designed to eliminate certain specific, potentially compromising, situations from arising to protect the individual, other members of the firm and the public. Individuals and their employers should not be placed in a situation where others could reasonably question their integrity, or their work, because of the existence of a conflict of interest.

Individuals and firms differ and a business activity that may be acceptable to one may not be to another, depending on the circumstances and any arrangements in place to remove or mitigate the effect of conflicts. For example, it is not the value or nature of an inducement which necessarily matters; it is the manner in which individuals or parties are actually influenced by the inducement, if at all, to the detriment of the customer.

Conflicts of interest can arise because of the differing roles that an intermediary may undertake as an agent, at times for the customer, at others for another principal (usually their firm) and in some instances for both at the same time. Under agency law, an intermediary is under an obligation to disclose to a client any relevant conflicts of interest.

A conflict management policy must be appropriate to each firm's business model, including its size and organisational structure, the expertise of its clients, the nature of the products it sells or administers and the type of activities it engages in. Larger organisations may consider appointing a conflicts officer to whom employees can refer matters, confidentially if necessary.

In addition to management controls and procedures, employees should be able to recognise when their actions are, or are likely to be, in conflict with the interests of their employer or, more importantly, their customer. In all cases, where measures designed to manage potential conflicts in the circumstances of particular services do not adequately reduce or resolve the prospect of conflicts arising, consideration should be given to withdrawing those services from clients.

6. The role of senior management

Senior managers should be fully involved in conflict identification and management. Although they do not need to be personally involved in every decision they need to assure themselves that decisions taken within the frameworks set up to identify and manage conflicts are consistent with their desired approach, for example that complaints are being approached openly and independently by supervisors or staff involved in resolving them.

Senior management must view risks and consider mitigation across the full range of activities for which they are responsible. Mechanisms should be in place to allow them to assess the totality of conflict within the firm and how this is being managed. Regular review work conducted within a firm by a compliance or internal audit department should test conflict procedures.

To achieve consistent treatment of conflicts of interest throughout their organisation, senior managers should set clear guidelines for their business which set out the type of activities in which conflicts cannot be adequately managed and which should therefore not be engaged in. Systems and controls should be designed to reflect the nature and seriousness of differing classes of conflict and the persons accountable for making decisions at differing levels identified. Guidelines should include the types of conflict which should be referred to senior management for a decision on whether the conflict can be mitigated.

7. Mitigating conflicts of interest

Methods of mitigation should be designed for the types of conflicts a firm has decided can be managed.

Some examples of methods which can be used to manage potential conflicts include:

- hospitality and/or gift register;
- restrictions on gifts and hospitality individuals may accept;
- information barriers or ‘Chinese walls’ between different business units to prevent free flow of confidential information;
- changes to remuneration arrangements for the firm and individual staff to avoid incentives and targets which may encourage poor advice or misuse of information;
- increased disclosure to clients and obtaining informed consents from them;
- information systems designed to provide timely and accurate information;
- reporting structures to build in checks and balances to promote objective judgement;
- recorded justification of decisions when selecting products or suppliers;
- documenting why and how recommendations are being made to customers;
- complaints handling and claims settlement procedures.

8. Corporate governance

Corporate governance plays an important role in the management of conflicts of interest. Problems arise when incentives drive the organisation to deliver shareholder value over customer satisfaction. Public interest representation on boards or non-executive ‘user’ councils can assist in assessing whether policies are working and firms are delivering on their promises.

9. Outsourcing

Where work is outsourced, the firm’s obligations to manage and deal with any conflicts of interest remain, so the relationship with their outsourcers should ensure that they also meet these obligations.

10. What the Code means for the individual

CII members must ensure that they conform to the provisions of the Code of Ethics and Conduct on conflicts of interest set out above. Additionally, the general principles of the code have effect as follows:

Members should behave with integrity in all their professional and business relationships. Integrity implies not only honesty but fair dealing and truthfulness. Any advice given or work undertaken must not be corrupted by self-interest or influenced to the detriment of personal integrity by the interests of other parties.

If members are instructed or encouraged to engage in any activity which is unlawful or improper (including where this is part of their contract of employment) they are entitled to and should decline. For example, members should not be party to the falsification of any record or knowingly or recklessly supply any information or make any statement which is false or deceptive.

If members become aware that their employers have committed an unlawful act which could compromise them, every effort should be made to persuade them not to perpetrate the act and to rectify the matter.

In making professional/business judgements and in giving opinions, members should not allow prejudice or bias or the influence of others to override objectivity.

The interests of a member's employer should not affect the objectivity of the member's judgement.

Members should be aware of the difficulties which may arise from the offer or acceptance of any gift, favour or hospitality which may be intended to influence them or may be reasonably interpreted by a person being in full possession of the facts to be likely to have such effect. Inappropriate gifts or hospitality should not be offered or accepted.

Any report prepared for a customer or employer should be accurate, truthful and, within its scope, complete and balanced. It should not contain ambiguities or half-truths or be based on unreasonable assumptions. It should be objectively justifiable.

The opportunity to have access to confidential information, if abused or misused, may confer an unfair competitive advantage. If members use or intend to use confidential information not reasonably available to the public for their own direct and substantial economic benefit, such conduct constitutes a conflict of interest. The same principle applies if they disclose or intend to disclose information to other individuals or organisations

in such a manner that a direct and economic benefit may be conferred on those individuals or organisations.

Any information acquired by a member from a customer should only be used or disclosed in the normal course of providing the service which the customer requires unless the consent of the customer has been obtained or information is required because there is a legal or regulatory obligation to disclose. When members change their employment they are entitled to use the experience they have gained in their previous employment but not confidential information acquired or received by them. If members acquire or receive confidential information deliberately or accidentally in the course of their professional work to which they would not otherwise have access, they should neither use, nor appear to use, that information for their personal advantage or the advantage of a third party.

Members should be honest and fair in the way they hold themselves out to customers either by means of advertising or in the description of their role or the service they can provide.

When members give information in order to secure work, they should ensure that it is:

- factual and relevant;
- not misleading or unfair.

Members should ensure that any advice, solutions and recommendations are based on thorough, impartial consideration and analysis of all the available pertinent facts and their relevant experience and are realistic and clearly understood by the client.

If members make a mistake they should not hesitate to admit the error, apologise and rectify matters promptly and fairly.

Members should take special care to be trustworthy and to uphold the best interests of clients at all times.

Members should not accept any financial or other incentive from whatever source that could be construed in any way as a bribe or solicitation or favour.

Members should always provide timely and accurate information to customers. They should make reasonable endeavours to ensure the truth and accuracy of every statement they make and any information provided to clients or to third parties and that they do not conceal any information which is pertinent.

10. What the Code means for the individual

Members should not misuse or abuse their power or position. They should act with courtesy and consideration and without discrimination towards any individual they encounter. This includes taking into account the likely level of understanding, financial or numeracy capabilities of customers.

Members should keep their promises.

Members should act only within the limits of their personal competence and any limits of authorisation.

Members should undertake professional work only where they have the necessary competence required to carry out that work, supplemented if necessary by assistance and consultation.

Members should use their best endeavours to comply with the relevant standards or, where they do not, ensure the reasons for such non-compliance are stated truthfully, unambiguously and fairly.

Action for CII members to take - Members should take all reasonable steps to resolve ethical problems internally within their firm. To resolve an ethical conflict it is suggested that members:

- Discuss the problem with their immediate supervisor. If this does not result in a satisfactory resolution their supervisor should be notified of the decision to communicate with a more senior manager. Where an organisation has an agreed grievance procedure this should be used.
- In circumstances where it appears the supervisor is involved in an unlawful act or a conflict, go immediately to a higher level of management, the Board of Directors or the Audit Committee, if available.
- If an ethical conflict still exists after fully exhausting all levels of internal review, consider 'whistle blowing' to FSA or to the CII.
- As a last resort, and in serious cases, there may be no alternative but to resign.

Some key questions for individuals to ask themselves

- Are my dealings with this customer (or my employer) transparent?
- Is what I am about to do or propose in the best interests of the customer?
- Am I being objective in giving opinions and statements?
- Am I being honest and truthful?
- Would I like to be treated in this way if I were a customer?
- If I act for this customer will it prejudice any obligations I owe to any other client?
- Why am I being asked to lunch (or to an event/function)?
- How would my actions look to, or be perceived by, a third party or my employer, and does this matter ethically?
- How would my actions look to my professional body?

11. A conflicts policy for financial advisers

The debate on conflicts of interest instigated by the RDR discussion paper has a number of facets. Whilst it is certain that remuneration issues, for example, will continue to be a hot topic in that debate, we propose, that side by side with any business solutions which emerge, clear guidance on professional standards for dealing with conflicts of interest should be issued to individuals and firms giving or supporting the provision of financial advice to the public. Conflicts policy within firms and applying to individuals should furthermore be transparent and open to scrutiny.

Our papers on the role of professional bodies and a new single independent professional standards board suggest a framework within which such guidance could be issued, promoted, monitored and enforced. Essentially, this framework would be led by the professional standards board which establishes and oversees a single framework of ethical and technical standards, and recognises professional bodies who would apply these standards to their members.

We would propose that the professional standards board and professional bodies should address the issue of conflicts of interest with high priority.

Part of this work, we recommend, should be consideration of the fiduciary duties owed by advisers to their clients. Our thinking here is that a financial adviser held to a fiduciary standard is required to act with undivided loyalty towards the client – a position which could potentially resolve many of the debates about ethical duties in this context.

It is worthwhile recalling here that one of the arguments for the establishment of polarisation in 1988 was to separate in the public perception advisers who primarily served the client (IFAs or brokers) from those who acted on behalf of another principal (ie their company). In the course of depolarisation we have lost the potential for that distinction to be fully developed through a reconsideration of the law of agency and fiduciary duties. The Law Commission is of course examining agency issues as part of its current work on insurance contract law and it may be that linking with that work will assist the professional standards board, particularly if the Law Commission were to conclude that clarification to the law of agency is needed.

12. Next steps

The questions posed in this paper are fundamental to the industry and will – we are sure – provoke comment. We welcome that debate, for it is only through debate that we will engage with the issues.

We would welcome your views on this paper. We believe that the issue of conflicts of interest and how they are managed is central to any discussion of the future of retail financial services. The CII Group believes it has a strong role to play here in helping the industry deliver the step change needed to convince regulators, policy makers and consumers that conflicts in the industry have been identified and that they are being managed appropriately.

We hope we have your support. We welcome your comments to inform our thinking.

Any views you have on this paper should be sent to David Thomson at the CII – david.thomson@cii.co.uk

The Personal Finance Society

Customer Service

42-48 High Road, South Woodford, London, E18 2JP

tel: **+44 (0)20 8530 0852**

fax: **+44 (0)20 8530 3052**

email: **customer.serv@thepfs.org**

website: **www.thepfs.org**

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