



Eidgenössische Bankenkommission
Commission fédérale des banques
Commissione federale delle banche
Swiss Federal Banking Commission

Incentive systems and conflicts of interest regarding the distribution of financial products

(SFBC-Report “Distribution compensation“)

Supervisory perspective

Discussion paper of the Swiss Federal Banking Commission

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Key points

Modern asset management is characterised by a value chain made up of numerous elements. A range of providers and intermediaries are involved in the entire process or with individual services. Throughout the distribution process, they are remunerated in part by means of distribution compensation. This takes the form of financial or other benefits given by the producers of financial products to their distribution partners. If these also have duties of loyalty to their clients, this can result in conflicts of interest. Those affected must address these conflicts in an appropriate manner to ensure that their clients are not disadvantaged. This applies just as much to the financial sector as to other areas of the economy such as the healthcare sector or the travel industry, where third-party products and services are distributed by people whose primary task has to be to advise their clients.

The SFBC has considered the issue of distribution compensation in investment fund business and the use of external asset managers several times in recent years. At the end of 2006 it decided to look in more depth at distribution compensation in relation to potential conflicts of interests, with a view to improving transparency with regard both to such conflicts and to distribution costs (Chapter 1). To this end it established an internal project group which, following preliminary research in the first half of 2007, conducted in-depth workshops with selected banks, asset managers and fund managers as well as with experts in this area (Chapter 2). This discussion paper is based on these workshops and presents a detailed insight into the value chain for asset management and for the distribution of financial products. It highlights the problems and conflicts of interest that can arise in connection with distribution compensation and sets out the measures, organisational and otherwise, that can be taken to ensure that these potential conflicts do not disadvantage clients (Chapters 3 and 4). The particular characteristics and business models for the distribution of investment funds, exchange traded funds and structured products (Chapter 5) and the status of “independent” or “external” asset managers (Chapter 6) are also presented in detail. The description of the legal framework is clearly geared towards Swiss supervisory law, but also touches on civil-law aspects and both European (MiFID) and German legislation. The SFBC is not a civil court judge, however, and therefore refrains from expressing any opinions on civil law. Aspects relating to criminal, competition and other areas of law are not covered (Chapter 7). Following a conclusion, the action required from a supervisory law perspective and the options for taking this action are put forward in Chapter 8.

The paper reaches the following conclusion: the currently dominant model for the distribution of financial products contains many conflicts of interest, as products are largely offered and distributed by producers and distribution partners (“pushing”), and only rarely actively demanded by clients (“pulling”). One reason for this could be the inadequate level of information and the lack of market power among smaller clients. In any event, other business models in which advisory costs are wholly covered by investors have so far failed to make a lasting impression. Relationships with institutional investors are very different, but the SFBC’s investigations did not find any indication that distribu-



tion compensation actually has a negative impact on the quality of asset management services. In fact, distribution compensation is likely to have little direct impact on product selection. All the providers observed have taken organisational precautions to guard against corresponding incentives for cheating their clients.

While the discussion paper is in favour of limited supervisory measures, it stops short of proposing any radical solutions. In particular, the SFBC believes it would be neither appropriate nor useful to force a change to the current distribution model by banning distribution compensation. Nor would the SFBC have the legal authority to do this. However, the SFBC is proposing greater non-product-specific transparency of distribution compensation for end clients (“point of sale disclosure”). Asset managers should inform their clients in advance of the calculation parameters and ranges for possible third-party distribution compensation for the various different product classes. Where requested by clients, amounts already received by third parties would also have to be disclosed, provided that with reasonable effort they could be clearly attributed to a specific client relationship (e.g. “retrocessions” on brokerage fees or custody fees). This step would also be largely in line with MiFID regulations and would justify the decision not to seek greater transparency of distribution compensation at the level of individual products, such as investment funds. This would be desirable in itself, but would require an international consensus to prevent competition distortions in cross-border business.

In parallel with this discussion paper the SFBC is also opening a hearing on a draft circular entitled “Cornerstones of Asset Management”. The circular already contains a proposal for a “point of sale disclosure” as mentioned above. This would not only cover the banks, securities traders and licence holders governed by the Collective Investment Schemes Act, but would also have to be observed by all asset managers whose industry organisations wish to have their professional standards recognised by the SFBC as minimum standards under the Collective Investment Schemes Act. Ultimately, therefore, it would encompass practically the entire asset management sector in Switzerland.



Questions for discussion participants

The SFBC would like to invite all interested parties to give their views on the issues raised in this discussion paper. Opinions are requested by 10 November 2008 and should be submitted in electronic form (e-mail or electronic data carrier).

In the absence of any indication to the contrary, the SFBC will assume that interested parties consent to their opinions being published.

Interested parties are asked to comment on the following questions in particular:

1. What are the practical implications of incentive systems and conflicts of interest regarding the distribution of financial products for the intermediaries involved in distribution and for institutional/private investors?
2. Should the SFBC in its capacity as the supervisory authority for banks and securities markets devote more time to these issues and to the distribution of financial products and conditions for distribution partners generally?
3. Should it adopt the most “non-product-specific” approach possible to ensure uniform treatment for all financial products which are equivalent from an investor perspective?

With a view to the impending integration of banking, securities and insurance supervision in the new FINMA authority:

Should a non-product-specific approach of this kind also include insurance products?

4. To what extent is action required under supervisory law, and which of the approaches presented in Chapter 8 should the SFBC continue to pursue where necessary? Are there any others?