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BITE-SIZE BRIEFINGS

July Ed No. 5

A series of briefings that take a "bite-size" look at international trends in different jurisdictions, drawing on Baker McKenzie's expert financial services practitioners.

Conflicts of interest and spread charges - a continuing focus for global regulators

Global financial regulators are maintaining their focus on the way that fees are disclosed to clients and factors, particularly compensation structures and conflicts of interest, which may encourage sales staff of financial intermediaries to inappropriately recommend or sell investment products.[1] This edition takes a bite-size look at regulatory initiatives aimed at reviewing and controlling pricing practices used by intermediaries and related issues of conflicts of interest in Hong Kong, Singapore, United Kingdom, and the United States.

Hong Kong

The Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) have continued to rank management of conflicts of interests and spread charge arrangements as top priorities. The SFC has specifically included this as a strategic priority in its latest annual report.[2] Reflecting this ongoing focus, the HKMA and the SFC have announced that in the second half of 2020, they will commence a concurrent thematic review of intermediaries' compliance with internal control and disclosure requirements. The regulators will assess and determine any further action depending on the nature and seriousness of their findings. Past proceedings and fines demonstrate that disciplinary action can be expected in case of breaches, so it is important for financial institutions to identify and address any deficiencies promptly.

We provide further guidance on potential areas to consider in preparation for the thematic review.

[1] This includes during reviews into Private Banking Sales and Advisory Practices in Singapore, the Financial Services Royal Commission in Australia, and prior disciplinary proceedings in Hong Kong and Singapore.

[2] https://www.sfc.hk/web/files/ER/Annual%20Report/2019-20/EN/SFC%20Annual%20Report%202019-20_EN.pdf

Regulatory requirements – Key points

The direct link between fees charged to clients and compensation creates potential conflicts of interest, which if not adequately identified and managed may lead to inappropriate business structures and non-compliant practices. For this and other reasons, regulators have imposed various conduct requirements, including pre-sale, point-of-sale and post-sale disclosure requirements. The key requirements relating to spread charges and other compensation/incentive arrangements in Hong Kong are summarised below:

General principles	– Avoid conflicts of interest and ensure fair treatment of clients.[3] – Ensure that charges, mark-ups or fees affecting a client are fair, reasonable and characterised by good faith.[4] – Ensure that any representations made and information provided to clients are accurate and not misleading.[5]
Selling process	– Disclose transaction-related information, including the following, prior to or at the point of entering into a transaction[6]: ▪ Capacity (principal or agent) ▪ Any affiliation with the product issuer ▪ Extent of independence ▪ Monetary and non-monetary benefits received ▪ Terms and conditions under which a client may receive a discount for fees and charges – Whenever an intermediary or its staff member(s) have an interest in a transaction with a client (being a direct/cross transaction), disclose this fact to the client prior to the execution of the relevant transaction.[7] – Provide clients with adequate information about the intermediary and the services to be provided to the client, together with other relevant risk-disclosure statements, as well as the nature and scope of fees, penalties and other charges the intermediary may levy.[8] – Disclose to the clients any information (e.g., order handling, mark-ups) as required under the Global Code of Conduct Standards and Practices for the Wholesale Foreign Exchange Market ("FX Global Code").[9]
Execution	Execute client orders on the best available terms when acting for, or with, clients.[10]

[3] Paragraph 10.1 of the Code of Conduct.

[4] Paragraph 2.2 of the Code of Conduct.

[5] Paragraph 2.1 of the Code of Conduct.

[6] Paragraph 8.3A of the Code of Conduct.

[7] Paragraph 6 of the Appendix to the Internal Control Guidelines.

[8] Paragraph 1(c) of the Appendix to the SFC's Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (Internal Control Guidelines).

[9] https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2017/20170928e1.pdf.

[10] Paragraph 3.2 of the Code of Conduct.

Post-trade	– Confirm promptly with the client the essential features of the transaction.[11] – Provide contract notes stating the capacity, actual execution price, commission, fees, charges, etc.[12]
Training and record keeping	– Licensed individuals should undertake Continuous Professional Training, addressing business conduct and ethical standards.[13] – Records of all contracts, fees, commissions, bid and offer prices for any leveraged foreign exchange contracts, and other items stipulated in the Securities and Futures (Keeping of Records) Rules and any supplementary internal policies and procedures need to be maintained.[14]

Details of joint thematic review

The joint thematic review recently announced by the HKMA and SFC[15] will focus on several key areas:

- Whether charges may be in excess of the spreads or fees disclosed in the intermediaries' standard documents to clients, or as agreed with or understood by the clients
- Whether spreads may be increased after a trade is executed and the price improvement is retained without agreement with, or disclosure to clients
- Whether intermediaries understand and properly disclose the capacity in which they are acting when conducting trades for clients

The review will cover selected intermediaries, and the regulators will consider their policies, procedures, systems and controls, as well as management oversight of the distribution to clients of non-exchange traded investment products, such as bonds and structured products.

Preparation

In light of the above, financial institutions should consider reviewing their existing spread charge arrangements and more broadly measures in handling conflict situations. Areas to consider include:

Structuring/Capacity/ Pricing	– Identify situations where internal business lines act in different capacities, and ensure that each respective team is aware of the capacity (e.g., principal or agent) in which they act and their associated obligations. – Ensure that interactions between internal and external third party teams are identified, appropriate agreements are in place, and the way in which fees are charged for these arrangements are properly documented. – Identify and track how any monetary fees and non-monetary rewards are determined and distributed (including by way of internal charging

[11] Paragraph 8.2(a) of the Code of Conduct.

[12] Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules.

[13] As required under The Guidelines on Continuous Professional Training made under section 399 of the Securities and Futures Ordinance, Cap. 571.

[14] https://www.elegislation.gov.hk/hk/cap571O.

[15] https://www.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=20EC44.

	arrangements or external rebates). Also, ensure that calculation methodologies take into account firm-wide fee structures (including where fees are payable across business lines), are clearly defined and documented, and are regularly reconciled for accuracy.
Disclosure	– Ensure that the capacities and duties of all internal and external teams serving the client are clearly and appropriately disclosed through product descriptions or service disclosures. – Confirm that all fee arrangements are disclosed to clients, and ensure that there is no ambiguity about the nature and types of fees that apply in any situation and that no secret commissions are received, especially where multiple levels of fees may be incurred on a single transaction. – Ensure that all conflicts of interest have been identified, logged and are disclosed to clients in an easy-to-understand manner and clients are given options to choose alternative arrangements, particularly if lower-cost options are available.
Internal policies and procedures	– Determine whether trading policies cover market movements or similar events resulting in execution of trades at prices either better or worse than originally notified to the client, and how any gains or losses are allocated. Also, ensure that any impact on spreads or fees is clearly communicated to and agreed with clients. – Ensure that policies and procedures are subject to regular review and update based on regulatory or market changes or prior outcomes, and they are consistently followed and any exceptions are documented and reviewed. – Confirm that methodologies used to ensure implementation of charges in accordance with any client agreements are fit for purpose and produce accurate outcomes. – Confirm that processes and procedures exist to notify clients, discuss, track and rectify any pricing errors at appropriate risk management committee and Responsible Manager level, and be able to demonstrate they have been effectively and consistently applied and explain resolution timelines.
Training	– Ensure all licensed individuals (and staff generally) have completed training on, and are familiar with, all relevant internal policies as part of or in addition to any applicable Continuous Professional Training requirements. – Ensure teams are trained on their fiduciary, ethical or contractual responsibilities during interactions between clients, internal and external teams, and service providers. – Analyse previous disciplinary actions by the SFC/HKMA and/or offshore regulators related to conflicts of interest, pricing arrangements, disclosures and client agreements, and determine any similarities in business models leading to potential risks.

Singapore

Reflecting its aim of continuing to safeguard client's interests and maintain Singapore's reputation as a leading wealth management hub, in February 2020, the Monetary Authority of Singapore (**MAS**) published its "Private Banking Sales and Advisory Practices - Observations and Supervisory Expectations from Thematic Inspections" Information Paper (**PBIF**)[16]. The findings of the sample-based review conducted in 2018 and 2019 suggest that Private Banking may be subject to many of the same potential misconduct issues that have been fertile ground globally for fines in the retail banking space. We discuss some of those areas and potential steps not just for Private Banks (**PBs**) but financial institutions generally to take in more detail below.

Review Focus

The MAS review underpinning the PBIF focused on four key themes that have been well trodden not only by the MAS but regulators in other jurisdictions. Those were:

- **Governance** - management oversight of the sale and advisory activities, including the extent to which relevant issues were escalated and deliberated upon by senior management, clarity of roles and responsibilities, as well as the establishment of appropriate frameworks and controls.
- **Investment Suitability** - frameworks and processes to ensure that clients receive appropriate financial advice and recommended products that are suitable, taking into account their risk appetites and investment profiles.
- **Pricing Controls and disclosures** - controls to promote transparency of fees on transactions, including disclosures to and communication with clients, and processes to ensure that pricing arrangements agreed with clients are adhered to.
- **Culture and conduct** - staff perceptions of front office culture, as well as tone-from-the top on organisation values and desired employee behaviour.

The MAS also took the opportunity to review remuneration processes that were not otherwise considered as part of the preparation of its separate 2019 "Incentives Structures in the Banking Industry – Fostering Sound Behaviour and Conduct" Information Paper.[17]

Details of joint thematic review - Key Findings

MAS observed that whilst PBs have largely adopted investment suitability and pricing disclosure standards set out in the Private Banking Code of Conduct[18] and Guidance on Private Banking Controls[19], the efficacy and rigor of these controls was not consistent across the sample group. Some PBs had good approaches that should be emulated whilst others required improvement. The results of the review included findings that:

- Clients were charged higher fees than agreed in advance without being informed or their consent having been obtained;

[16] https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Monographs-and-Information-Papers/Private-Banking-Sales-and-Advisory-Practices.pdf.

[17] https://www.mas.gov.sg/publications/monographs-or-information-paper/2019/incentive-structures-in-the-banking-industry-fostering-sound-behaviour-and-conduct.

[18] https://www.abs.org.sg/docs/library/pb-code-of-conduct-14-feb-2020.pdf.

[19] https://www.mas.gov.sg/publications/monographs-or-information-paper/2014/guidance-on-privatebanking-controls.

- Market movements to the client's advantage between the PBs advising an execution price and actually executing the trade were not passed on and the benefit was kept by the PBs without disclosure to or agreement by the client;
- Processes and procedures were not adequate to identify that incorrect fees had actually been charged and resolve the situation in a timely way;
- Clients were marketed products with higher risk than the client risk assessment rating allowed and there was failure to have adequate pre or post trade monitoring processes to prevent or detect and address the mismatch in a timely manner;
- There was a view by some PBs employees that completing a risk appetite statement for a client was a mere paper exercise (and it was not meant to influence or impede sale of products to the client); and
- There was failure to promote an appropriate culture within the organisation including lack of clarity between financial and non-financial or behavioural targets and front office staff not being able to translate organisational values into day-to-day behaviours for their roles.

MAS Regulatory requirements – Recommendations

Based on its findings the MAS has published six categories (referred to as "Box 1-6") of key desired outcomes. With respect to pricing arrangements, the key recommendations are contained in Box 5 and provide that Banks should:

- Communicate to clients, and agree with them, the fees, charges and any other quantifiable benefits in a timely and transparent way. This includes providing clients with fee schedules on charges for all categories of investment products and services, and informing clients of any revisions on a timely basis.
- Disclose deviations from fee schedules and bilaterally agreed pricing arrangements to clients on a timely basis, and obtain clients' agreement or "no objection" to the deviations.
- Disclose and agree with clients how benefits from price improvements arising from client transactions are allocated, and establish controls to adhere to such arrangements.
- Implement adequate and effective pre-trade controls to prevent, and post-trade checks and surveillance to monitor and detect, unauthorised deviations from fee schedules and bilaterally agreed pricing arrangements.
- Review post-trade amendments to price or spread to verify if these were authorised, justified and accurate.

Actions to Consider

The MAS expects financial institutions to benchmark themselves against the PBIF outcomes and take steps in a risk-appropriate manner to address any gaps between the regulatory expectations in Box 1-6 and current processes. Financial Institutions, regardless of whether they are a Private Bank, premier or priority bank service should at a minimum:

- Review the PBIF in detail and identify relevant internal processes and procedures that are associated with addressing each of the conduct items in the MAS' defined Boxes;
- Undertake and document a gap analysis between the current state compared to the MAS' expected state (including the basis for any conclusions reached);

- Determine the appropriate methodology and necessary timelines to remediate any identified gaps or client impacts and ensure that they are communicated appropriately to and overseen by senior management and, if necessary, communicated to the MAS as part of any breach reporting processes; and
- Ensure that senior management are communicating these actions to all employees and the employees understand the importance of complying and underlying reasons for them.

The MAS has stated its intention to engage in further discussions regarding its PBIF findings with financial institutions as part of any future reviews. Failure to undertake a timely appropriate internal review and identify and initiate remediation steps will expose a financial institution not only to regulatory enforcement risk, but also to client complaints and potential litigation with associated reputational damage.

United Kingdom

There is rightly concern over pricing practices by firms and intermediaries where not all their charges are adequately disclosed (or at all) in respect of the distribution to clients of investment products such as bonds and structured products. Over recent years the position of intermediaries with respect to pricing (or charging) and conflicts of interest has been addressed through a number of regulatory initiatives and publications. Besides the high-level requirements in the Financial Conduct Authority's Principles for Businesses to treat customers fairly, within its Conduct of Business Rules is to be found the "best interests rule" - which obliges firms to act honestly, fairly and professionally in accordance with the best interests of their clients in relation to investment business, insurance distribution and UCITS funds. A similar rule applies to alternative investment fund managers. These rules also provide that firms should provide information in a comprehensible way to clients about, for instance, costs and associated charges so they can take investment decisions on an informed basis.

Regulatory requirements – Key points

By way of background, in 2012, the then Financial Services Authority published the outcome of, and implemented, the Retail Distribution Review (RDR). This was followed in 2016 by the Treasury's and the FCA's findings in the Financial Advice Market Review (FAMR). In summary, the RDR made significant changes to the way investment products are distributed to retail consumers, including changing the way that charges and services are disclosed, as well as banning the use of commission to pay for advice for investment products. Under FCA rules, charges must be clear to consumers and advisers must disclose the charging structure to clients upfront and in writing. At their heart these reforms, which were also reflected in Recast EU Markets in Financial Instruments Directive (MiFID 2), look to address the inherent conflicts of interest between intermediary and client arising from commission-based remuneration and to make the cost of advice more transparent. The FAMR, in turn, sought to respond to issues including access to advice arising from the end of commission in the RDR, as well as canvassing issues of adviser charging. In 2019, the FCA published a call for input to evaluate the RDR and FAMR[20] and publication of the review's findings are expected in autumn 2020.

As noted, conflicts of interest requirements are central to this topic. Their proper management is a key principle of financial services regulation with a view to achieving fair, orderly and efficient financial markets. Firms must have policies commensurate to the nature and size of their businesses. A recent FCA supervisory report looked at payment for order flow (PFOF) arrangements and their potential to create a conflict of interest as they incentivise firms to execute their clients' orders with counterparties

[20] https://www.fca.org.uk/publications/calls-input/evaluation-rdr-famr.

based on the latters' willingness to pay commissions.[21] Clients are potentially disadvantaged because PFOF makes it more likely that additional, non-transparent, costs will be passed on to them due to wider bid-ask spreads set by market makers to meet the cost of paying commission.

Actions to Consider

Most recently, in its 2019/20 business plan[22], the FCA referred to conflicts of interest as representing a sector priority for retail investments and wholesale financial markets, and has prioritised its supervision of this area. It has reminded financial advisers, wealth managers, and platforms that investment products should have transparent features, risks and charges. Firms which design and sell retail investment products to consumers should ensure that any conflicts of interest are managed effectively. Regulated entities should take steps to ensure that they are complying fully with the respective requirements in order to mitigate against regulatory and client risk.

United States

Concerns about the adequacy of disclosure, and conflicts of interest, related to pricing, and more specifically, to fees and costs associated with the purchase of investment products are firmly tied, in the US, to regulators' focus on protecting retail investors and those saving for retirement. The bottom line is, well, the bottom line. Excessive fees and costs degrade investment performance and result, over time, in less overall retirement savings. Absent pension regimes, US investors rely heavily on retirement savings, so these are meaningful investor concerns that transcend any political affiliation or administration, as such, we anticipate these issues to remain in the spotlight. In addition, regulators have taken notice that higher fee investment products often pay higher rewards to the firm and/or the individual representative selling to the investor, representing conflicts of interest requiring disclosure, at the least, if not mitigation, or even elimination, of that conflict risk.

Regulatory requirements – Key points

Recently, we have seen something of a transition from regulation of these issues largely through enforcement actions to actual rulemaking. For example, the Securities and Exchange Commission, through its Division of Enforcement, has brought a long line of cases[23], including a self-reporting initiative, charging investment advisers with breaches of fiduciary duty for failing to disclose that they had selected for clients a mutual fund share class that paid a fee to the adviser (or an affiliated broker-dealer), when a lower cost share class of the same fund was available. These cases highlighted issues about conflicts of interest, what comprised adequate disclosures of such fees and expenses, and even sales practices, supervision, and compliance policies and procedures related to how investment products are sold.

More importantly, these enforcement actions marked the beginning of a now continuing trend of regulatory actions concerning how firms and their representatives are compensated in connection with sales of investment products. Among the questions posed through these matters is whether products offering the investor the least cost, in the way of fees and expenses, or the most available discounts, in the form of fee waivers[24], by way of example, are the ones being sold to investors. These types of issues remain key among regulator interests, as described in the SEC's Office of

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[21] https://www.fca.org.uk/publication/multi-firm-reviews/payment-for-order-flow-pfof.pdf.

[22] https://www.fca.org.uk/publication/business-plans/business-plan-2019-20.pdf.

[23] https://www.sec.gov/enforce/announcement/scsd-initiative.

[24] https://www.finra.org/media-center/news-releases/2019/finra-announces-final-results-mutual-fund-waiver-initiative.

Compliance Inspections and Examinations 2020 Examination Priorities.[25] Should firms fail to heed the lessons of these prior enforcement matters, they can anticipate their examinations will end in noted deficiencies and potential referrals to Enforcement for investigation.

Finally, on the topic of regulation by enforcement, following on the comments from our colleagues in the UK, we have seen additional interest by regulators on the issue of payment for order flow in connection with equity trading. This practice, while indeed generally compliant with current rules, does chafe under the mantle of conflicts of interest, particularly when coupled with the concept of best execution. FINRA has specifically identified this issue in its 2020 Risk Monitoring and Examination Priorities Letter[26], so we fully expect to see more on this topic.

Swimming against the deregulation tide so evident in the rest of the current administration, recently, the SEC has undertaken real rulemaking related to these issues, first, finally meeting its Dodd-Frank mandate by passing Regulation Best Interest, which became effective June 30, 2020. (This recent Client Alert[27] discusses Reg BI implementation developments.) While too complex to explain fully in a "bite," Reg BI imposes a new standard of conduct on broker-dealers, requiring that they act in a client's best interest, and mandates the review of conflicts of interest with an eye toward mitigation, and even elimination, of those conflicts, where possible. While not raising the conduct standard to the fiduciary duty imposed on investment advisers, Reg BI does meaningfully alter broker obligations. On the same day that Reg BI was announced, the SEC also took the opportunity to require both broker-dealers and investment advisers to disclose to clients their conflicts of interest, among other issues, on Form CRS; and also provided guidance to investment advisers on how to meet their fiduciary obligations to clients.[28] Front-and-center in the SEC's Reg BI package of releases, you will find these issues related to transparency on fees and expenses, as well as conflicts disclosure and mitigation.

Actions to Consider

The SEC has proposed revisions to the rules governing investment adviser advertising and solicitation, each of which also touch on these cost transparency and conflicts issues.[29] The comments process is underway and we will see where the changes to these important regulations land.

Although the frontal attack on Reg BI in the courts has been stymied for the moment, as firms make individual efforts to implement the new rule, as some states decide that Reg BI does not go far enough and propose their own statutory regimes, and as the US Department of Labor has now introduced its own Fiduciary Rule, there continues to be some uncertainty regarding the full nature of the obligations owed by broker dealers. It will be critical to continue to watch developments in this area and take a proactive and flexible approach.

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[25] https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.

[26] https://www.finra.org/rules-guidance/communications-firms/2020-risk-monitoring-and-examination-priorities-letter.

[27] https://insightplus.bakermckenzie.com/bm/dispute-resolution_1/united-states-a-closer-look-at-regulation-best-interest-implementation-developments?_sm_au_=iVVL8FLSRCVF8MrjKkM6NKsW8f6TG.

[28] https://www.sec.gov/news/press-release/2019-89.

[29] https://bakerxchange.com/rv/ff0054f99b541da316f0df7b9040a5eeeddc790e.

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