



Jersey Financial
Services Commission

Themed Examination Programme 2017: Suitability of Investments

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Glossary of terms

The following table sets out a glossary of terms used in this report.

AML	Anti-money laundering
CFT	Countering the financing of terrorism
JFSC	Jersey Financial Services Commission
FSJL	Financial Services (Jersey) Law 1998, as amended
the Order	Money Laundering (Jersey) Order (2008)
the Handbook	the Handbook for the Prevention and Detection of Money Laundering and the Financing of Terrorism
Code	Code of Practice for Investment Business
MLCO	Money Laundering Compliance Officer
MLRO	Money Laundering Reporting Officer
PEP	Politically exposed person
DB Pension	Defined Benefit Pension Scheme

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1 Executive summary

1.1 Introduction

This paper provides an overview of findings from the Jersey Financial Services Commission's (JFSC) themed programme of on-site examinations on the subject of Suitability of Investments, which were conducted by the JFSC in Q2 2017, whereby a total of ten investment business firms ('investment firm' or 'registered person')¹ were subject to examination.

The JFSC's key observations in this paper are drawn from its findings of those examinations.

1.2 Background

In response to increasing concerns around investment advice, in early 2017, the JFSC embarked on an Island-wide public awareness campaign highlighting the potential dangers of high-risk investments and mis-selling. As a continuation of the on-going work in this area, the JFSC carried out a series of themed on-site examinations to a cross section of Jersey based investment firms which are licenced to provide both investment advice and discretionary investment management services.

The high level objective of those examinations was to assess the extent of compliance of the investment firms with the Code, having particular regard to Principle 2 of the Code which requires a registered person to *"have the highest regard for the interests of its clients"*.

1.3 Scope and regulatory requirements

In terms of the detailed requirements of Principle 2 of the Code, the examinations reviewed and assessed:

- › The investment firm's documented knowledge of the client's circumstances and investment objectives;
- › Due diligence conducted by the investment firm on products and/or providers in terms of their suitability for its clients;
- › The suitability of advice provided or discretion exercised by the investment firm for its clients; and
- › The effectiveness of the investment firm's review processes in respect of all of the above.

The examinations also considered the investment firm's compliance with Principles 3² and 4³ of the Code, and any relevant guidance issued by the JFSC.

¹ A person registered by the Commission under Article 9 of the FS(J)L to carry on investment business as defined under Article 2(2) of the FS(J)L

² A registered person must organise and control its affairs effectively for the proper performance of its business activities, and be able to demonstrate the existence of adequate risk management systems.

³ A registered person must be transparent in its business arrangements.

1.4 Objectives and limitations

The JFSC regularly undertakes on-site examinations on specific themes to: (1) assess the extent to which regulated entities are operating in accordance with their regulatory obligations under the respective Laws, Orders, Codes of Practice and Guidance Notes; (2) provide direct feedback to the firms examined; and (3) issue related guidance for the wider industry.

The JFSC's on-site examination programme is designed to assess the risks faced by individual entities and review the controls, procedures, policies and processes in place to mitigate those risks.

The purpose of this paper is to summarise the key findings from these themed examinations, and also to provide, where noted, areas of good practice observed by way of example⁴. It is not intended to comprehensively describe all risks that may be associated with non-adherence to regulatory obligations and not all firms face the issues described below. However, the observations made reflect areas of potential risk and are provided for general guidance.

1.5 Methodology

Prior to each examination, the JFSC requested a range of policy and procedural documents from the investment firm being examined. This information was assessed before the on-site examination commenced. During the examination, JFSC officers reviewed a sample of client files from a list of clients obtained beforehand and held discussions with management and staff. The files were reviewed to determine whether procedures were being adequately followed and to establish the extent of any control deficiencies. The findings were based upon information provided by the investment firm and evidence available at the time of the examination. Where findings have been made, these are being separately addressed between the individual firm and the JFSC.

Policies, procedures and client files were reviewed by reference to the examination scope, and through tests designed to assess the firm's compliance with the requirement to have the highest regard for the interest of its clients. Specifically, these tests included assessment of:

- › The completeness and thoroughness of the fact finding exercise undertaken to determine the most suitable products for clients, taking into account their needs; and
- › The means by which client investment risk profiles are ascertained and the nature and extent of communication with the client to ensure their full awareness and understanding of the risks associated with particular products or strategies.

⁴ The areas of good practice observed and referenced herein should not be taken as formal guidance issued by the JFSC as they may not be relevant or appropriate to every registered person.

2 Key observations

2.1 Fact Find - Knowledge of Client

Documenting and maintaining adequate client information will assist an investment firm in ensuring that client information is comprehensive, accurate and up-to-date.

It is disappointing that, in a number of investment firms examined, the fact find process was found to be deficient. Evidence was seen of:

- › Documentation which did not contain fields which would enable exploration of, for example - the client's capacity for loss, current financial situation and investment risk appetite. In other instances, documentation was only partially completed.
- › Documentation being updated or amended without reference as to why this had occurred or when such updates or amendments took place.
- › Documentation did not include version control to ensure relevant members of staff were using the most up-to-date version of the document.
- › Comments being made to a client suggesting that the fact find questions may be intrusive and suggesting that the client not disclose all of their financial circumstances.

The JFSC reminds investment firms that in instances where the client fact find process is only partially completed or not updated properly, this may result in that investment firm providing unsuitable advice.

2.2 Reasons Why Letter (RWL) or Suitability Letter

The RWL is a key document in terms of evidencing suitability of investment(s).

The RWL provides comprehensive information in respect of the investment advice provided, with the aim of enabling the client to make an informed investment decision. It was of concern therefore that a number of investment advisors failed to adequately document the rationale for selection of specific investment products in their RWL. Evidence was seen of:

- › Repeated use of standardised wording not specific to each individual client's requirements and a lack of care in personalising RWLs to clients' individual circumstances.
- › No clarity being provided as to how the asset allocation had been arrived at, accompanied by a repeated lack of supporting documentation to explain and support the proposed asset allocation.
- › No, or insufficient, information being provided about the individual risks of each product identified.
- › Not aligning the client's risk tolerance to the risk level of the investment recommendation.
- › In some cases, the content of the RWL appeared to be designed to take advantage of consumer biases to persuade clients to make certain financial decisions.
- › The rationale and advice regarding the sale of an investment was not sufficiently documented.
- › No documented proof that consideration had been given to various alternative products or providers (a compare and contrast exercise).
- › Lack of documented detail to show a true understanding of the client's financial information, investment time horizon(s) and wider investment portfolio – this ties in with findings already identified in section 2.1 (Fact Find).
- › No evidence that diversification or concentration risk have been considered.
- › Written risk warnings provided being generic in nature and not tailored to the client's individual circumstances. In some instances they were absent altogether.

- › Reliance being placed on the client to have read and fully understood key financial documents and information provided with the RWL, or hyperlinked within the RWL. This was done instead of explaining the risks to the client in a 'clear and concise' way within the RWL.
- › In one instance, a client had signed the Client Agreement, Fact Find, RWL and DB Pension Transfer Request all on the same date without any written explanation as to why this had occurred. This indicates that the client was not provided sufficient time to reflect on the advice before making a decision.

The JFSC reminds firms that the RWL should present a clear and balanced view to the client, highlighting any advantages and disadvantages associated with the specific recommendation, thus allowing the client to make an informed decision.

Good practice identified:

- › RWLs setting out the particulars of the product in an easily understandable language; where the charges that the client would incur as a result of the investment were clear and concise and showing what remuneration the advisor would receive; a balanced view of the product versus the risks associated with the investment; and why the product was suitable for the client given their individual circumstances.
- › An investment advisor's manager or supervisor attending at least one client meeting a month jointly with the advisor to understand if advice being provided is suitable and providing appropriate feedback to the advisor following the meeting.
- › A committee being in place (Risk & Compliance or similar) that reviews investments during a defined period (for example monthly or quarterly) to ensure consistency and quality of the RWLs and, in turn, suitability of investments.

2.3 Defined Benefit Pension Scheme Transfers

The irreversible nature of transferring out of a DB Pension, and the potential impact of unsuitable advice being given to clients by an investment firm advising a client to transfer their DB Pensions represents a high degree of risk to clients and the firm.

DB Pensions cannot readily be replicated and careful consideration should be given before a client relinquishes the benefits associated with it. In respect of DB Pension transfers, evidence was seen of:

- › A lack of in-depth assessment of client needs - including alternative solutions to meet those needs and why the DB Pension transfer suggested was most suitable for the clients.
- › Inadequate fact finding to establish the client's financial situation.
- › A lack of financial projections and comparison of future investment returns required to match the guaranteed benefits provided under the DB Pension, including the advantages of indexation having been carried out.
- › Non-specific or generic risk warnings only provided in the RWL.
- › Insufficient explanations of the impact on benefits at retirement.
- › No evidence that the income required in retirement, and potential longevity risk, had been established or considered.
- › It is a UK regulatory requirement that, with regard to UK DB Pension schemes, clients must have taken advice from a UK FCA authorised advisor before making a transfer, this is commonly referred to as a Transfer Value Analysis System Report (**TVAS Report**). An investment firm had utilised the services of a UK based entity to provide a TVAS Report, only subsequently to ascertain that the UK FCA had barred the UK entity from providing that service. The investment firm had not fully considered any resultant implications it may encounter from the client should potential unsuitable advice claims be made.

- › In other instances where a TVAS report was utilised, inconsistencies in the RWL were noted regarding relevant risk warnings associated with the transfer option suggested.

Investment firms will be aware from the JFSC Professional Indemnity Insurance (PII) Review results issued in December 2017⁵, that PII policies specifically exclude claims linked to advice/services provided in respect of DB transfers.

Good practice identified:

- › Board minutes reflecting the board's acknowledgment and consistent consideration of the risks to the business associated with DB Pension transfers. Similar reference also being noted in Business Risk Assessments together with corresponding controls being put in place.
- › Where an investment firm had taken measures to ensure a client obtain a TVAS report, the firm then took the time to consider the report and factor this into the advice they were giving to their client.
- › The use of a disclaimer in the RWL when a client wished to proceed with a DB Pension transfer against the advice of the advisor. The disclaimer set out in detail the advisor's concerns as they did not believe it to be in the best interest of the client and was explicit in highlighting that the transfer was only being done at the insistence of the client.

2.4 Fees

The Code (4.6) requires a registered person to *'demonstrate in writing that the client has been made aware of all associated fees and charges...effectively a 'no surprises' policy. This information must be disclosed prior to transactions being effected and information concerning commissions, fees and charges must include either a monetary or percentage figure'*. Evidence was seen of:

- › Inconsistent patterns of fee charges associated to different clients (with similar circumstances) by different advisors within the same investment firm. No explanation or rationale for the level of differing fees agreed was provided or supported.
- › Fees being quoted as percentage figures alongside a projection of benefits without demonstrating any monetary impact the initial charge (or subsequent charges) would have on the lump sum invested or the cost to the client to do business. Undue reliance was therefore being placed on the client to calculate the breakdown of fees, which if complex and considered with all other information such as fee structure and service options, may lead to an incorrect or misplaced understanding of fees charged by the firm.
- › Correspondence with a client stating that the Fund Manager was charging an upfront fee of a certain percentage when in fact the firm had negotiated that no front end fees would be charged by the Fund Manager. The upfront fees quoted actually were all receivable by the investment firm.
- › Clients being charged a higher annual management fee than those recorded within their schedule of fees without a clear documentation as to why this was the case.

Good practice identified:

- › Clients being made aware (in advance of any service being provided) of all relevant fees, charges and remuneration in respect of the specific recommendation, together with a description of any ongoing charges.

⁵ <http://www.jerseyfsc.org/media/1622/pii-feedback-paper-dec-2017.pdf>

2.5 Annual/periodic reviews

The annual/periodic review is a continuity check to ensure that the relevant documentation in respect of the client, and any services provided, has been fully completed and held on the client file(s). The review process also includes, but is not limited to, consideration of the suitability of the advice, the adequacy of the client's risk assessment (taking into account any changes to the client's circumstances), and the appropriateness of any investment strategy applied to the client.

In some instances, whilst there was evidence that annual/periodic reviews were being monitored on systems, summary information was not being reported to senior management to enable oversight of the review process at that level.

Annual/periodic review processes were not being actively managed and reliance was being placed on individual advisors to diarise accordingly which was not always effective in practice.

2.6 Vulnerable clients

The JFSC considers a vulnerable persons policy to be an important control mechanism for an investment firm to have in place when dealing with clients who may require additional care, assistance or support. Such a policy would assist the investment firm to evidence that it has 'the highest regard for its clients'. The JFSC is aware that, in certain circumstances, vulnerable clients may be more susceptible to placing undue reliance or excessive trust in their financial advisor. It is therefore imperative that an investment firm is able to demonstrate that its internal controls and review processes are robust in this regard.

The JFSC found evidence that some of the investment firms had not formally implemented controls and review processes, which may be beneficial in recognising and handling clients that require additional care, assistance or support.

The JFSC also noted that, whilst having guidance in place to identify and appropriately deal with vulnerable clients, it had not always been embedded within a firm's formal policy and procedures for when meeting new clients. In turn, this led to numerous instances whereby there had been a failure to identify a client as vulnerable and document that such consideration had taken place.

Good practice identified:

- › Internal Policies and Procedures that clearly set out:
 - › Who may constitute a vulnerable client (not solely restricted to age but inclusive of other factors such as mental capacity, changes in personal circumstances (loss of job) or other life changing events (bereavement) which occur over time that may affect their capacity to think and act rationally and clearly (ties in with observation at 2.7 below)).
 - › How vulnerable clients should be treated, for example an identified vulnerable client should be offered the opportunity to be accompanied to meetings by a close relative or trusted third party.
 - › What extra measures are required when dealing with vulnerable clients (for example record keeping) to ensure that the business is protected from any complaint that the advice provided and investment made was unsuitable.

2.7 Changes in client circumstances

It is important that investment firms are able to recognise any changes to a client's circumstances which could ultimately impact the suitability of their current investment products and any services provided to them.

Good practice identified:

- › An annual review checklist sent to all clients to ensure information held is relevant and up to date to ensure any change of circumstances is captured.

2.8 Remuneration of employees

In one instance, the JFSC noted that an investment firm was remunerating relevant staff with a basic salary and a discretionary bonus that may be paid at the year-end dependent on the volume of fees/commission generated by the investment employee. This was done without formally documented KPI's aligned to the quality of advice given and best client outcomes. The remuneration model potentially exposed the investment firm to mis-selling and conflicts of interest.

Good practices identified:

- › A move away from predominantly sales based remuneration.
- › Some firms recognise best client outcomes as a KPI in their remuneration model.

2.9 Policies and procedures

Instances were seen of poor controls over the ownership and maintenance of policies and procedures. The absence of an audit trail creates difficulty for staff, auditors and regulators to understand, and be aware of, material changes made, and when these were effected.

The following instances were noted as being omitted from formal policies and procedures reviewed:

- › monitoring and reviews
- › fund suspensions
- › compliance monitoring
- › new business checklist completion
- › annual and periodic reviews
- › providing services to clients not resident in Jersey
- › dealing with Vulnerable Persons

Policies and procedures need to be kept up to date so that changing regulatory requirements are fully considered.

Good Practice identified:

- › Procedures have been devised for managing those clients who insist on deviating from a suggested recommendation.

2.10 Record keeping

In several instances, there had been a failure to clearly document the discussions held with the client (an audit trail) particularly in relation to conclusions reached regarding the client's investment risk appetite, capacity for loss, and investment objectives. This observation is closely associated with those made in 2.1 and 2.2 above.

Disorderly files, with key documents missing, potentially reflect a poor understanding of a client and a related risk. They also hinder oversight controls, including audit attempts (internal and external) by key members of staff, auditors and regulators. This observation was particularly disappointing when advance notice had been given of an intended examination, including details of the client files to be sampled.

2.11 Business acceptance

Where New Business Committees (howsoever called) were convened to receive, consider, agree (or otherwise) a new client, or to consider the provision of additional services to a client, in some instances it was found that the recording of the Committee discussions held could be improved on in order to fully demonstrate that an informed decision had been reached as to the acceptability of the client and/or additional proposed service.

2.12 Product Due Diligence

The JFSC observed that, in certain instances, a full assessment of the features and characteristics of the products considered suitable for its clients by the investment firm had not taken place, or had not been documented sufficiently to support their inclusion on the Approved Product List (also referred to as the 'White List').

In one instance it was noted the Approved Product List was not subject to version control to ensure that all relevant staff members were using the most up-to-date and accurate version of the document.

The JFSC reminds investment firms of the importance of version control when it comes to documentation which will be used by, referred to, or relied upon by its staff.

Good practice identified:

- › Well-structured committees in place for reviewing investment products for inclusion onto the Product List and documenting evidence of why.

2.13 Switching

In reviewing client files, the JFSC had due regard to those files which identified a high frequency of replacement business being written for a client. Instances were found whereby, due to a lack of documentation in respect of alternative products or options having been considered, there was no evidence to confirm that switching was always in the best interests of the clients. This observation ties in with those found in 2.10 (Record Keeping).

The JFSC encourages Investment firms to review their policies and procedures to ensure they highlight the potential for unnecessary switching and have in place appropriate controls to identify and discourage such practice.

2.14 Compliance function

A registered person is required under the Code (3.5) to ensure that the Compliance Officer is responsible for ensuring appropriate monitoring of operational performance and managing regulatory and compliance risk within the registered person. The Code also establishes a requirement for a board to adequately monitor the registered person's business, including the implementation of a Compliance Policy.

It was observed that the Compliance Officer was not always in attendance at relevant meetings which monitor the operational performance of the business. Participation in live, strategic discussions relating to the business and any emerging issues will strengthen the Compliance Officer's ability to demonstrate fulfilment of their obligations under the Code.

In respect of oversight of the Compliance function by the Board, a number of areas of weaknesses were identified, for example:

- › Compliance reports to the board were found to be insufficiently detailed, were 'cut and pasted' from previous board reports; or were sporadic in the timing of their submissions.

- › No target dates for actions were noted or continuously extended, with no challenge from the board.

All investment firms are reminded to assess their policies and procedures to ensure those relating to Compliance and Board oversight comply with regulatory requirements, and any reporting to the Board is sufficiently detailed to identify any areas of concern.

2.15 Risk Assessment Tool ineffective or non-completion of Risk Assessment

Section 3.3.4 of the Handbook is concerned with the assessment of risk. It was noted on several occasions that investment firms had failed to undertake adequate (or, in a few instances, any) risk assessments on its clients. Trigger events, such as annual reviews, had also not highlighted these omissions.

Risk assessment tools used to assess the money laundering or terrorist financing risk posed by clients, such as spreadsheets, had not been reviewed and updated to encompass changes in legislation/regulatory requirements. Country of residence or location of business activities are two such key drivers for overall risk assessment of clients, a regular review of country or territory risk is essential to ensure clients are risk rated correctly and the relevant level of due diligence requirements is applied.

2.16 Complaints

In several instances, the JFSC noted that registered persons had failed to revise and update their complaints procedures and Terms of Business to reflect the role of the Channel Islands Financial Ombudsman (launched in November 2015) (**CIFO**) when dealing with client complaints. This suggests that those registered persons were slow to recognise and react to the establishment of CIFO and could not demonstrate compliance with paragraph 3.6.1.7 of the Code.

Where complaints had been recorded in the Complaints Register it was not always the case that the registered person would record how a complaint had been resolved nor that any root cause analysis had been undertaken. Full completion of the Complaints Register will enable the registered person to collate meaningful management information and identify emerging patterns from complaints received.

2.17 PEPs

Procedures concerning PEPs should be drafted to fully recognise the requirements of the Order and the Handbook, ensuring all relevant members of staff can determine whether a client is a PEP, and how they should be dealt with.

The JFSC reminds registered persons that, once a person has been identified as a PEP, the introduction of timescales within a procedure for when that PEP status can be removed does not comply with Article 15 (6) of the Order, paragraph (5), which states a “*politically exposed person*” means a person who is – (a) an individual who is **or has been** [emphasis added] entrusted with a prominent public function in a country or territory outside Jersey or by an international organization outside Jersey, for example...”.

2.18 CDD (including Source of Funds and Source of Wealth)

Section 3 of the Handbook sets out identification measures required under Article 13 of the Order. It is disappointing that the JFSC identified instances where investment firms failed to obtain the required level of CDD from clients (at the commencement of the relationship or on an ongoing basis).

In one instance the CDD reviewed identified a number of factors that were not commensurate with the 'low' risk rating subsequently applied to the client. It was apparent the investment firm had inappropriately considered and documented its risk assessment despite a number of 'red flags' being present within the CDD documentation, resulting in a concern that its systems and controls were ineffective, or its staff were not asking the right questions to fulfil the investment firm's AML obligations.

There was also confusion seen in the understanding of, and difference between the terms, 'source of funds' and 'source of wealth'. It was noted that generic terminology was used such as 'income'; 'Earnings'; and 'Personal Account' to describe both source of funds and source of wealth. These terms are not sufficiently robust to meet regulatory requirements. It is essential that relevant staff clearly understand the difference between these two terms (Section 3.3.3 of the Handbook).

2.19 Conflicts of Interest

On several occasions, it was identified there had been a failure to identify, record and manage conflicts of interest.

In one instance, whilst a conflict of interest policy was in place, it was found to be heavily UK centric and did not make reference to, or reflect, paragraphs 2.9 and 2.10 of the Code.

Several instances were identified where the Compliance Officer held multiple positions within a registered person (a multiple of Director, CO, MLCO, MLRO, Company Secretary). These conflicts had not been identified by the Board and logged on the Conflicts of Interest Register or, where they had been identified, it was not detailed as to how the Board was actively managing the conflicts.

The JFSC reminds registered persons that they should have a Conflicts of Interest policy in place which is regularly reviewed and applied.