



Jersey Financial
Services Commission

› **Investment Business:
Examination Feedback 2014 and 2015**

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› Introduction

This paper sets out the summary findings from the Jersey Financial Services Commission’s (“the Commission’s”) programme of onsite examinations conducted during the calendar years 2014 and 2015.

The purpose, objective and process of the programme remain unchanged. For further details, please see the Summary Findings Document published at the address below:

<http://www.jerseyfsc.org/pdf/On-Site-2013-Examination-Feedback-October-2014.pdf>

Please note that references to specific paragraphs within the Codes of Practice for Investment Business (the “IB Codes”) relate to the IB Codes which became effective 1 July 2008 and were last revised 1 July 2014.

› Scope

The Commission conducted 27 examinations during 2014 and 25 during 2015. The examinations fell into the following categories.

Examination	2014	2015
Supervision Examinations	10	15
Themed – Suitability of Investments	17	10
Total	27	25

The programme of Supervision Examinations comprised reviews covering Conduct of Business, Corporate Governance and Internal Systems and Controls.

The principal theme for both 2014 and 2015 was suitability of investments.

› Outcome

In almost all cases, those Registered Persons forming part of the examination programmes were provided with individual examination reports identifying areas where they had not been able to demonstrate full compliance with their regulatory obligations. The resulting remediation required to address shortcomings was tracked via the issuing of a Post Examination Monitoring Schedule (“PEMS”).

› Overview of Findings

During both 2014 and 2015, the Commission identified a number of instances where the Corporate Governance arrangements of Registered Persons did not meet the required regulatory standards. Consequently, individuals forming the Regulatory Span of Control could not demonstrate that they were adequately engaged with key business risks. Recommendations were made in relation to reviewing the risks present in the business, establishing additional management committees and ensuring that an appropriate range of topics were reported to and discussed by the Board of Directors (or a committee thereof).

The Commission had a number of findings regarding Registered Persons failing to conduct adequate reviews of the conflicts of interest arising within their businesses and/or instances where they could not demonstrate that these were being appropriately managed.

A number of recommendations were made to Registered Persons in respect of enhancing their systems and controls in relation to the following matters:

- › Switching and Churning;
- › Compliance Resourcing, Monitoring and Reporting;
- › Product approval (including product due diligence);
- › The monitoring of outsourcing arrangements;
- › The failure to seek the necessary consents from the Commission;
- › Suspicious Activity Reporting; and
- › Client Money Laundering (“ML”) Risk Assessments.

The Commission continued to observe conduct of business failures in relation to the application of client due diligence (“CDD”) measures. Such failures included inadequate certification of documents and insufficient records relating to the source of client funds, the failure to undertake enhanced due diligence in higher risk situations, and incomplete or inaccurate policies and procedures relating to this area.

Other conduct of business findings included the failure to adequately tailor suitability letters to reflect why a Registered Person’s recommendations were deemed suitable for the client’s circumstances and objectives, insufficient explanations of the level of investment risk, insufficient client and product knowledge, and inadequate disclosure of all associated fees and charges.

› Corporate Governance Findings

Risk Assessment

The Commission encountered several instances where Registered Persons had conducted a risk assessment, but these did not appear to adequately identify and record the primary risks arising within businesses. The IB Codes require that all risks, not just ML risks, are identified, as are the ways in which they are to be monitored and controlled. The Commission’s anticipation is that a comprehensive risk assessment should inform the design of an appropriate compliance monitoring programme that is tailored to the risks of the business.

The Commission made recommendations to a number of Registered Persons to enhance their risk assessments in relation to specific risks that were identified by the Commission, including ML matters.

Oversight of Branch/Subsidiary by local Senior Management

Principle 3 of the IB Codes establishes the requirement for Registered Persons to organise and control their affairs effectively for the proper performance of their business activities. In two instances the Span of Control of a Jersey branch failed to demonstrate sufficiently robust arrangements. Recommendations were made in relation to the effectiveness of management committees, which included enhancing the breadth of matters discussed.

Oversight of Investment Activities

The Commission continued to observe instances where Boards of Directors were not adequately engaged with business risks arising from investment activities. In a number of examinations the Commission made recommendations to firms to strengthen the Board of Directors’ (or committees thereof) oversight of investment matters. Such matters included:

- › Best execution;
- › Misleading or inadequate client communications;
- › Churning and unnecessary or inappropriate switching;
- › Portfolio performance;
- › Product performance and suitability;
- › New product due diligence; and
- › New business.

Several Registered Persons were required to improve their oversight of outsourced investment activities. Those Registered Persons were reminded that, as set out in the Commission’s Policy Statement and Guidance Notes on Outsourcing, there should be agreed performance standards set out in a service level agreement

with service providers and that these should be supported as necessary by appropriate management information. Such standards should be no lower than those existing within the Registered Person.

Conflicts of Interest

The Commission continued to identify instances where Conflicts of Interest were not being adequately identified or managed. Examples were identified where the Registered Persons' Board of Directors had not implemented a Conflicts of Interest register or policy, or in instances where a register and policy had been introduced, the Registered Persons were unable to demonstrate that their Conflicts of Interest registers were formally considered by the Board of Directors on a periodic basis. In addition, there were instances where Registered Persons had a Conflicts of Interest register in place, however, it did not reflect all conflicts arising within the business. For example, specific staff related conflicts and conflicts inherent in business models or specific products, including bias towards particular products or investment services.

The IB Codes require that Registered Persons must endeavour to avoid any conflicts arising and, where conflicts do arise, policies and procedures must be in place to ensure that these conflicts are effectively identified, managed and controlled. Adherence to these policies and procedures should form part of compliance monitoring testing. In addition, the Commission expects Registered Persons to record their conflicts within a register, and for this to be formally reviewed by the Board of Directors on a periodic basis.

Compliance Function

During several examinations the Commission identified shortcomings in the compliance functions of Registered Persons. Such shortcomings included instances where the resources available to the compliance function were not deemed to be adequate for the businesses, compliance monitoring did not take into account all of the compliance risks arising as a result of the Registered Person's activities and the extent of reporting to the Board of Directors (or a committee thereof) in respect of compliance monitoring activities was inadequate.

As highlighted in the Commission's "Dear CEO" letter issued in December 2013, the Commission considers that compliance monitoring should form an important part of a Registered Person's risk management framework. As such, it is important for senior management, including the Board of Directors, to be actively engaged with compliance monitoring, including the approval of a compliance monitoring plan ("CMP"), and receiving regular updates in respect of the progress of the CMP and information relating to findings and associated actions arising from the monitoring activity.

The Commission views the compliance function as being central to a Registered Person's adherence to the regulatory requirements imposed upon it, and as such does have serious concerns when it identifies instances where the compliance function is either not appropriately resourced, or does not receive adequate support from the Board of Directors in the performance of its duties.

› Conduct of Business Findings

Switching and Churning

In a number of instances, the Commission detected weaknesses in Registered Persons' controls in relation to the risks of inappropriate switching and/or churning of investments. Given that paragraphs 2.11, 2.12 and 2.13 of the IB Codes set out specific requirements in this respect, it was disappointing to discover failings in eight examinations over the two year period, with one firm lacking any formal controls in this regard.

A fundamental aim of the Review of Financial Advice was to reduce the potential for fee bias to influence advice. As a consequence it was hoped that the risk of inappropriate switching would be reduced, however, the risks remain; many Registered Persons were still found to be charging an upfront fee on investments made. The Commission expects that, where a Registered Person makes a recommendation to switch into a new service or product, it can demonstrate why it is in the client's interest to do so. Such recommendations should clearly set out any differences in costs, advantages versus disadvantages, and how these relate to the client's personal needs. Information should be presented in a balanced manner, without bias.

The Commission also expects that where clients are advised to switch from an investment product, as defined under Schedule 1 of the Financial Services (Jersey) Law 1998, to a product which is not covered by Schedule 1, suitability letters should contain very strong and clear reasons for the suitability of any switch, including a clear rationale as to why the redemption-side of the switch is considered suitable. Suitability letters should clearly highlight the specific risks associated with such products and include reference, where relevant, to the fact that the product may not be subject to the same level of regulation as a Schedule 1 investment product.

There were a number of examples where Registered Persons were not maintaining adequate records of switches and/or failing to measure the level of turnover on client portfolios. Recommendations were made to a number of Registered Persons to develop appropriate management information, in order that the Board of Directors could demonstrate appropriate oversight of these risks.

Product approval process

A high level principle of the IB Codes requires that Registered Persons must act with skill, care and diligence to fulfil the responsibilities that they have undertaken. In order to comply with this principle, Registered Persons are expected to have undertaken sufficient product due diligence prior to making recommendations to their clients.

The IB Codes reinforced this principle through the introduction of an explicit requirement that product due diligence must have been conducted before recommendations or investments could be made. The Commission was disappointed to discover that several Registered Persons had not established formal procedures in this regard.

The Commission made recommendations to a number of Registered Persons to enhance their procedures in respect of properly identifying product risk factors, with a view to reducing the likelihood of misrepresenting the risks associated with investing in certain products. It is expected that, where Registered Persons are recommending complex or alternative products, a greater degree of product research and due diligence should be undertaken.

In relation to structured products, the Commission made recommendations to a small number of Registered Persons to establish limits and/or guidelines to advisors in relation to the concentration of credit risk in respect of the issuer and underlying financial instrument(s).

Suspicious Activity Reports (“SARs”)

The Commission identified weaknesses in the policies and procedures of a number of Registered Persons which prevented them from evidencing a clear audit trail in relation to their SAR process. In one example, a SAR was ultimately reported to the Jersey Financial Crimes Unit (“JFCU”), however no formal internal SAR had been submitted to the MLRO and recorded on the SAR register. As a result, the Registered Person was unable to verify the timeframe in which the matter had been reported. In order for a Registered Person to demonstrate sufficient oversight and a clear audit trail in relation to its SAR process, the Commission expects that Registered Persons maintain a SAR register to enable them to monitor and identify any trends that may evolve. The register should include details of the following:

- › The nature of the suspicion;
- › The date the suspicion arose;
- › The date the suspicion was reported to the MLRO;
- › The rationale for escalating the report to the JFCU (or not); and
- › The JFCU’s consent to act.

At the time of some of these examinations it was not a mandatory requirement for a Registered Person to maintain a SAR register, however it was considered by the Commission to be best practice. Part 1, Section 8.3.1 and Section 8.3.2 of the revised AML Handbook now requires a Registered Person to record all internal and external SARs in a register.

Client Money Laundering Risk Assessment (“ML Risk Assessment”)

The Commission noted examples where there was either no evidence in the client files to demonstrate that a ML Risk Assessment had been undertaken or, where these reviews had been completed, there was no evidence that they had been completed in accordance with the Registered Person’s own policies and procedures. Such procedures should adequately consider a wide range of money laundering risk factors, such as those detailed in Section 3.3 of the Handbook for the Prevention and Detection of Money Laundering and the Financing of Terrorism (the “AML Handbook”).

The Commission identified examples where a Registered Person’s policies and procedures stipulated that external data sources should be used to verify whether a client was a Politically Exposed Person and/or connected to any negative press. In a number of instances no evidence was found to suggest that these checks had been completed.

The Commission also identified instances where a Registered Person was placing reliance on introducers/intermediaries (referred to as Obligated Persons in the revised AML Handbook) to have conducted identification measures for clients. The Registered Person had not conducted a risk assessment of these firms, and had not introduced policies and procedures to manage the risk of placing reliance on these firms. Such risks should be considered by Registered Persons prior to placing reliance on third parties in respect of CDD.

In addition, the Commission noted instances where CDD exceptions were identified as part of the Registered Person’s AML review process, however, there was no documentary evidence to explain what action the Registered Person would take to remediate these exceptions.

The Commission would expect a Registered Person to have sufficient systems and controls in place to ensure that client AML reviews are completed and that documentary evidence is held to demonstrate that the Registered Person has complied with its own policies and procedures and the relevant legislation and Codes.

CDD

In a number of instances, Registered Persons did not hold adequate CDD. Examples were identified where certified documents did not include an adequate level of information in relation to the certifier, insufficient address verification documents were held and passport copies were not of an acceptable standard to be able to identify the client. In instances where Registered Persons were holding certified copies of CDD provided by regulated trust and company services providers, the CDD was not certified in accordance with Section 4.4.3, paragraph 74 of the AML Handbook. The Commission also noted cases where insufficient information relating to the source of funds and source of wealth was held, with some Registered Persons only recording the source of funds as being the remitting bank’s name or an inadequate explanation, for example simply stating “inheritance”.

Section 3.3.3 of the AML Handbook states that Registered Persons who are simply recording the remitting bank’s name may be confusing source of funds with the record keeping requirements of the Money Laundering (Jersey) Order 2008 (the “MLO”) and AML Handbook “which require information concerning the remittance of funds to be recorded (e.g. name of the bank and the name of the account number of the account from which the funds were remitted)”.

Section 3.3.3 of the AML Handbook confirms source of funds to be “the activity which generates the funds for a customer e.g. a customer’s occupation or business activities”. Accordingly, the Commission expects a Registered Person to provide a full explanation as to how the funds have been generated. The Commission also expects Registered Persons to include a detailed explanation as to the source of wealth, where required. Section 3.3.3 of the AML Handbook states source of wealth as being the “activities which have generated the total net worth of a person i.e. those activities which have generated a customer’s funds and property”. The Commission noted that a number of Registered Persons appeared to confuse source of funds with source of wealth, and vice versa.

The Commission noted a number of client files which had inadequate CDD, but had been reviewed by the Registered Person as part of its on-going AML review process. It appeared that these inadequacies had either

not been identified, or in instances where these inadequacies were identified it was not clear what remedial action the Registered Person had decided to take.

The Commission reminds all Registered Persons of the requirements under Article 13(1)(c) of the MLO and Section 3.3.6 of the AML Handbook, to have identified, as part of its on-going AML review process, any deficiencies in documentation, data or information. The Commission expects a Registered Person to obtain updated CDD where deficiencies are identified.

Suitability letters

The Commission observed a number of instances where suitability letters had not been sufficiently tailored in order to explain why the Registered Persons' recommendations were suitable for the client's specific circumstances and/or objectives. The Commission made a number of recommendations to Registered Persons to improve their disclosure of key product risks and to highlight whether any alternative products or services had been considered, and if so why they were discounted.

Evaluating and explaining the level of investment risk to clients

The Commission made recommendations to several Registered Persons in respect of possible improvements to advice provided to clients regarding the level of investment risk they should accept in pursuit of their investment goals. In one instance a Registered Person was using a third party risk questionnaire document to assist in its assessment of the clients' ability and willingness to take risk, with the output being a score from 1 to 10. The Commission found that the explanation provided, in order to define what the scoring meant in terms of the Registered Person's investment solutions, was insufficient. Such explanations could usefully have included details of exposure to asset classes and historical and expected ranges of returns.

Disclosure and transparency of fees and charges

The IB Codes require Registered Persons to disclose all fees and charges to their clients. The Commission made recommendations to a large number of Registered Persons to improve such disclosures. A frequent finding was that, whilst Registered Persons had disclosed to their clients initial commission received in relation to life assurance, recurring commissions had not been communicated. Other examples of shortcomings in respect of fee disclosures were in respect of dual currency investments and custody arrangements.

› Conclusion

The purpose of the on-site examination process and subsequent examination report is to set out examples where Registered Persons have not demonstrated full compliance with the regulatory framework. This report has been provided for the general guidance of those Registered Persons that did not participate in the on-site examination process during 2014 and 2015.

The applicability of these findings to any one Registered Person will depend on the investment business registration held, however all Registered Persons are urged to consider the feedback for 2014 and 2015, along with feedback from previous years and guidance already issued by the Commission.

The Commission would highlight that a number of matters summarised in this report tended to be indicative of underlying procedural weaknesses, specifically covering the area 'Conduct of Business'. Accordingly, the Commission would remind all Registered Persons of the importance of robust review and challenge of existing policies and procedures.