



Jersey Financial Services Commission

INVESTMENT BUSINESS

SUPERVISION EXAMINATION PROGRAMME 2013: SUMMARY FINDINGS

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1 INTRODUCTION

1.1 Objectives and Limitations

1.1.1 This report provides an overview of the findings from a series of on-site examinations conducted by the Investment Business division of the Jersey Financial Services Commission (the “**Commission**”) as part of its supervision of investment businesses.

1.1.2 The purpose of an on-site examination is to assess the extent to which a regulated business with an investment business registration (a “**Registered Person**”) is operating in accordance with its regulatory obligations under the respective Laws, Orders, Codes of Practice, Guidance Notes and the Handbook for the Prevention and Detection of Money Laundering and the Financing of Terrorism (the “**AML Handbook**”).

1.1.3 The Commission’s on-site examination programme is designed to:

- Assess the risks faced by Registered Persons and to review the controls, procedures, policies and processes in place to mitigate those risks;
- Obtain a greater understanding of a Registered Person’s activities, thereby enabling the Commission to focus attention on higher risk areas; and
- Take into account existing relevant information, review the resolution of any previous examination issues and to obtain assurance on any deficiencies highlighted through off-site supervision.

- 1.1.4 The purpose of this paper is to summarise the key findings from these on-site examinations. It is not intended to comprehensively describe all risks that may be associated with non-adherence to regulatory obligations and not all Registered Persons face the issues described in this report. The observations made are provided for general guidance.
- 1.1.5 The investment business industry covers a wide spectrum of different businesses, including independent financial advisers, boutique discretionary managers, brokers and the local operations of large multi-national financial services groups. The applicability of the findings summarised in this report to any one Registered Person is dependent on the classes of investment business registration held.

1.2 Methodology

- 1.2.1 This report draws upon the findings of 25 on-site examinations conducted by the Commission's staff during 2013. The Supervision Examinations covered the following areas:
- Conduct of Business;
 - Corporate Governance; and
 - Internal Systems and Controls.
- 1.2.2 Those Registered Persons that were part of the on-site examination process were provided with individual examination reports, setting out findings where the Registered Person had not been able to demonstrate full compliance with its regulatory obligations.
- 1.2.3 Please note that references to specific paragraphs within the Codes of Practice for Investment Business (the "**IB Codes**") relate to the IB Codes in effect at the time of the examinations.

2 CONDUCT OF BUSINESS FINDINGS

2.1 Suitability of Investments

The risk of a Registered Person mis-selling an investment remains a key area of focus for the Commission and there were a number of instances identified during 2013 where systems and controls required strengthening, as set out below in 2.1.1 to 2.1.4, in order to better demonstrate suitability of investments.

2.1.1 Knowledge of Client

The Commission identified instances where the fact find document or client questionnaire was incomplete or only partially completed, with no explanation for this. In accordance with paragraphs 2.3 and 2.5 of the IB Codes, Registered Persons are required to demonstrate sufficient knowledge of their clients by obtaining, documenting and maintaining information in relation to their clients' circumstances (financial or otherwise). This client information allows Registered Persons to better demonstrate suitability of advice, having regard to their clients' circumstances and investment objectives.

An example of good practice was demonstrated where the Registered Person, in instances where a client declined to disclose full information in relation to their circumstances and investment objectives, included within the suitability letter specific risk warnings highlighting to a particular client that the lack of such information may adversely affect the service it can provide. The Commission noted examples of good practice where the Registered Person also requested the client to sign and return the suitability letter to acknowledge this additional risk.

2.1.2 Concentration Risk/Counterparty Risk

The Commission identified instances where the Registered Persons' investment advice had resulted in a large percentage of clients' assets being invested in one single investment but the Registered Persons were unable to demonstrate that the associated concentration risk/counterparty risk had been clearly communicated to clients, in accordance with paragraphs 2.5 and 2.6 of the IB Codes.

An example of good practice was demonstrated where the Registered Person had clearly explained in its client proposal/recommendation that the apparent concentration risk/counterparty risk arising from the advice had been adequately considered and communicated to the client during the advice process in order that the client could make an informed investment decision.

The Commission would expect all Registered Persons to ensure that relevant policies and procedures require consideration of concentration risk/counterparty risk as part of the suitability assessment and ensure that these risks are clearly communicated to clients.

2.1.3 Establishing the level of investment risk a client is willing and able to take

The Commission identified instances where the level of investment risk embraced in a client portfolio was not in line with the client's stated risk profile and that the rationale for this difference had not been adequately explained. In order to demonstrate compliance with paragraphs 2.5 and 2.6 of the IB Codes, the Commission would expect the difference in risk levels to be clearly highlighted in the suitability letter.

The Commission noted that a number of Registered Persons use a risk assessment questionnaire in order to assess and document a client's risk appetite. However, examples were identified where the questions were either vague or not clearly worded, which could result in the client misunderstanding the questions and not giving answers that accurately reflect his or her risk appetite.

The Commission expects Registered Persons to ensure that evidence of client discussions in relation to a client's risk appetite are clearly documented on the client file.

An example of good practice was demonstrated where the Registered Person recognised the limitations of its risk assessment questionnaire and ensured that any conflicting answers provided by the client were highlighted and discussed with the client in order to clarify the level of risk they were willing and able to take. These discussions were clearly documented and referred to in a suitability letter that explained the rationale for the client accepting a higher level of risk.

In light of the above, the Commission would encourage all Registered Persons to consider whether amendments should be made to their own investment risk assessment process.

2.1.4 Switching and Churning

Whilst on-site, the Commission identified instances where a Registered Person had advised its client to switch his/her investments. However, the advantages and disadvantages of making the switch were not adequately explained and the client proposal/recommendation had focused solely on the expected returns of the new investment. In order to demonstrate compliance with Paragraphs 2.10 and 2.11 of the IB Codes, the Registered Person must be able to evidence, in writing, why it is in the client's interest to switch and it must ensure that it is not advising its client to enter into transactions with unnecessary frequency.

In an example of good practice, the Registered Person had clearly listed both the advantages and disadvantages of switching, including a comparison of fees and charges, in a suitability letter in order to allow the client to make an informed decision.

The Commission would encourage all Registered Persons to consider whether their own investment processes would ensure that the above matter is appropriately addressed, considered, documented and monitored.

2.2 Disclosure/Transparency of Fees and Charges

Paragraph 4.6 of the IB Codes requires a Registered Person to adopt a “no surprises policy” in relation to fees and charges and to ensure that these are clearly communicated to clients, in writing, in either a monetary or a percentage figure. However, the Commission identified instances where clients were not informed of the fees being taken by the Registered Person or where the Registered Person had failed to inform the client of charges being deducted by the product provider and/or failed to highlight surrender penalties in a suitability letter.

In cases of good practice, the Registered Person had clearly listed all associated charges in a suitability letter and had considered the impact of these charges on expected future returns.

The Commission would expect a Registered Person to ensure that it can demonstrate that all associated fees and charges have been clearly disclosed, in writing, to its clients. Additionally, the Commission would encourage all Registered Persons to consider whether amendments to their own policies and procedures are required in this respect.

2.3 Product Approval Process

The Commission observed instances where Registered Persons relied solely on a volatility figure in order to determine an investment’s level of risk. An example was identified where, despite the investment being complex and having numerous higher risk factors detailed in the prospectus, such as the use of leverage, the Registered Person had categorised the investment as being low risk.

In order to demonstrate that an investment product is suitable, in accordance with paragraphs 2.5 and 2.6 of the IB Codes, the Commission would expect a Registered Person to evidence that it has considered, amongst other matters, the use of leverage, liquidity of the underlying assets, including whether these are traded on mainstream markets, product complexity and the extent of regulatory oversight of the product or investment.

An example of good practice was noted where the Registered Person considered a wide range of risk factors before approving investment products through its prescribed investment approval process, with a summary of the overall level of risk being provided to clients in a suitability letter, allowing them to make an informed investment decision. Whilst this would seem obvious, the Commission was surprised by the number of Registered Persons who had not included such information within their suitability letters.

3 CORPORATE GOVERNANCE FINDINGS

3.1 Oversight of Investment Advice Cycle and Product Approval Process

The Commission would expect a Registered Person to evidence appropriate oversight of the investment services it provides, by demonstrating that all relevant investment discussions and decisions are formally recorded and escalated to the Board of Directors (the “**Board**”). Specifically, a Registered Person should ensure that consideration and subsequent approval or rejection of a new investment product, and the monitoring of existing products, is clearly evidenced and escalated, as appropriate.

One way that Registered Persons can effectively demonstrate oversight of their investment business activities is to ensure sufficient and appropriate management information is produced and reviewed on a periodic basis. However, the Commission noted a number of instances where insufficient management information prevented a Registered Person from demonstrating that it maintained accurate and reliable records and had sufficient oversight of its investment recommendations.

3.2 Compliance Monitoring Programme (“CMP”)

To enable a Registered Person to demonstrate compliance with paragraph 3.5 of the IB Codes, the Commission would expect a Registered Person to establish a robust and effective CMP in order to ensure:

- compliance with the relevant Laws, Orders and Codes; and
- appropriate monitoring of operational performance and promptly instigating action to remedy any deficiencies in such arrangements.

The Commission would expect a Registered Person’s CMP to form part of its overall risk management framework. Accordingly, a CMP must be appropriately tailored to the risks present within a Registered Person’s business. However, the Commission identified a number of instances where the CMP was not adequately tailored. For example, there were instances where a high frequency of monitoring was performed on lower risk areas, whilst high risk areas were only tested once a year.

The Commission noted examples where the Registered Person’s CMP had identified non-adherence to internal systems and controls; however, it did not document what remedial action was required and who was responsible for completion of these tasks. The Commission also identified examples where there was no record of the conclusion of the remedial action or the date on which it was completed.

Additionally, the Commission noted that the CMP did not always refer to the relevant Laws, Orders and Codes. Registered Persons should also refer to the Commission’s Guidance Note: Compliance Monitoring (Issued 6 December 2013) which is available on the Commission’s website:

<http://www.jerseyfsc.org/pdf/GN-Compliance-Monitoring-6-December-2013.pdf>

Finally, the Commission identified a number of instances where Registered Persons were unable to evidence that findings from the CMP were reported to the Board. In one case, the Registered Person's Board had never reviewed the effectiveness of its CMP.

In order to demonstrate compliance with paragraph 3.5.3.4 of the IB Codes, the Commission would expect the Compliance Officer to escalate findings from the CMP to the Board for consideration. Appropriate escalation of these findings to the Board provides an opportunity for the Compliance Officer to present any recommendations that he or she may have and, therefore, allows the Board to determine whether to act upon these recommendations.

3.3 Business Risk Assessment ("BRA")

To ensure compliance with the requirements of the IB Codes and AML Handbook, a Registered Person must ensure it has assessed the risks faced by its business, documented these risks and provided details of how these risks are monitored and controlled. The AML Handbook requires that the Board's assessment of the Registered Person's risk must be assessed on an on-going basis. Examples of risks that a Registered Person may wish to consider are, but are not necessarily limited to:

- Country Risk;
- Market Risk;
- Operational Risk;
- Liquidity Risk;
- Regulatory/Compliance Risk;
- Legal Risk;
- Reputational Risk;
- Financial Risk;
- Fraud/Criminal Risk;
- Key Person Risk; and
- New Product Risk.

To fully comply with the requirements of the IB Codes, a Registered Person's risk assessment should be holistic and not focused only on addressing the requirements of the AML Handbook. Such holistic risk assessments may be documented separately from the BRA.

The Commission identified examples where the BRA consisted of generic risk categories (for example, operational risk) but did not provide further details in relation to the Registered Person's exposure and management of operational risks specific to the business. For example, the Commission would expect the BRA to highlight how a breakdown of controls relating to the advice cycle could increase the Registered Person's exposure to the risk of providing incorrect advice, or not providing advice when it would be appropriate to do so.

The Commission noted that, in a number of cases, the Registered Person's Board did not consider the effectiveness of its BRA on an on-going basis. The Commission identified one particular example where the Board had not reviewed its BRA for a period of three years.

In light of the above, the Commission would encourage all Registered Persons to review and update, where necessary, relevant policies and procedures to ensure compliance with the requirements of the IB Codes and the AML Handbook, specifically covering the requirement for the Board to review and consider the effectiveness and appropriateness of the BRA on a regular basis.

3.4 Conflicts of Interests

The Commission considers the identification and management of actual and potential conflicts of interest as fundamental to a Registered Person's regulatory risk framework. The IB Codes require Registered Persons to take reasonable steps to avoid, where possible, conflicts of interest and, where conflicts do arise, the Registered Person must have adequate policies and procedures in place to ensure these are disclosed and appropriately managed. It is incumbent upon the Registered Person to ensure that there are effective controls in place.

The Commission noted a number of instances where conflicts were not identified or recorded within a Conflict of Interests Register. There were also instances where conflicts were recorded; however, the register did not record the date on which a conflict was identified.

The Commission also observed instances where recorded conflicts were not being managed in the manner required by the Registered Person's Conflicts of Interest Register.

4 INTERNAL SYSTEMS AND CONTROLS FINDINGS

4.1 Client Due Diligence (“CDD”)

The Commission noted a number of instances where Registered Persons were unable to fully demonstrate compliance with Sections 3 and 4 of the AML Handbook. All Registered Persons are required to demonstrate sufficient knowledge of their clients by way of collecting and maintaining appropriate CDD.

The Commission’s findings identified that there is some confusion amongst Registered Persons as to when confirmation of source of funds and source of wealth is required. Section 3.3.3 of the AML Handbook stipulates that source of funds must be documented for all clients, whereas confirmation of source of wealth is only required for higher risk clients. However, the Commission noted that confirmation of source of wealth is frequently requested, irrespective of the client’s risk rating, whereas the requirement to obtain confirmation of source of funds was regularly omitted.

The Commission also identified a number of instances where insufficient enhanced due diligence was held for those clients categorised as Politically Exposed Persons; guidance in this respect is provided in Section 3.4 of the AML Handbook.

Whilst the above matters indicate areas of procedural weaknesses, they also identify a need for Registered Persons to consider whether sufficient training has been provided to employees.

4.2 Intermediary/Introduced Relationships

In accordance with Articles 16 and 17 of the Money Laundering (Jersey) Order 2008, effective in 2013 (the “MLO”) and Section 4.10 of the AML Handbook, a Registered Person is permitted to rely on the identification measures previously applied by an appropriate intermediary or introducer. However, this may present additional risks that must be appropriately considered and addressed by the Registered Person in order to demonstrate compliance with the requirements of the MLO and AML Handbook.

The Commission had a number of findings in this area, spanning two key aspects. In a number of instances, the Registered Person had not implemented a formal methodology to risk rate intermediaries or introducers. Additionally, a number of Registered Persons were unable to demonstrate compliance with Section 4.10.3 of the AML Handbook, which stipulates that a Registered Person placing reliance on an intermediary or introducer must be able to demonstrate that it has obtained relevant client information from the intermediary or introducer. Specifically, the Commission identified examples where Registered Persons had relied on an introducer to demonstrate compliance with the CDD requirements of the AML Handbook but, whilst introducer certificates were held on the client file, not all key information was captured, such as all relevant controllers to the account.

4.3 Periodic Reviews of CDD/Anti-Money Laundering (“AML”) Risk Ratings

The process of periodically reviewing client files for compliance with internal policies and procedures is common practice within investment businesses and is seen by the Commission as a key control to enable Registered Persons to demonstrate compliance with the IB Codes as well as the AML Handbook. Whilst the Commission noted that, in the majority of cases, Registered Persons were able to demonstrate an effective periodic review cycle, in some instances the Commission identified the following:

- management information was insufficient to allow the Registered Person to complete a summary of the status of its periodic reviews or to demonstrate that reviews had been completed within the prescribed frequency;
- the review process did not require the reviewer to consider the client’s AML risk rating or CDD and decide whether any updates in this respect were required; and
- the frequency of reviews for low and standard risk clients was not prescribed. The Commission would expect a Registered Person to adopt a risk based approach in this respect and, where any additional risk factors are identified during the review process, amend client information and AML risk ratings.

4.4 Personal Account Dealing (“PA Dealing”)

A robust PA dealing policy is an important control against the potential risk of insider dealing and market abuse. The primary purpose of a PA dealing policy is to manage the potential conflict of staff dealing on their own account as well as for clients, to ensure that the Registered Person is acting in the best interests of the client at all times. This requires the Registered Person to ensure systems are in place to guard properly against involvement in financial crime, fraud and market abuse.

However, the Commission identified a number of instances where the PA Dealing Policy did not include specific reference to the Insider Dealing and Market Manipulation legal provisions, as set out in Part 3A of the Financial Services (Jersey) Law 1998.

Additionally, there were a number of instances where the Commission identified weaknesses in a Registered Person’s systems and controls, which prevented it from fully evidencing/demonstrating adherence to its PA Dealing Policy. For example, instances were identified where policies required pre-approval of all staff trades; however, PA Dealing approval forms were dated after the trade was dealt or the time of pre-approval was not recorded.

Finally, the Commission noted instances where PA Dealing did not feature prominently in the CMP. Its inclusion enables a Registered Person to test whether appropriate approval has been obtained and to evidence that instances of non-compliance have been identified, escalated and remediated, as appropriate.

5 CONCLUSION

- 5.1.1 The foregoing is not intended as formal regulatory guidance, nor should it be taken to cover all relevant aspects of the subjects touched upon.
- 5.1.2 Those Registered Persons that were part of the on-site examination programme were open and co-operative throughout the examination process, for which the Commission was appreciative and grateful.
- 5.1.3 The purpose of the on-site examination process and subsequent examination report is to set out findings of Registered Persons having 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.
- 5.1.4 The applicability of these findings to any one Registered Person will depend on the classes of investment business registration held.
- 5.1.5 However, 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 to assist a Registered Person to comply with the relevant Laws, Orders, Codes and Guidance Notes.
- 5.1.6 The Commission would welcome comments on any of the contents of this report and would also be happy to address any concerns or questions that the reader may have. Any such communications should be addressed to the relevant supervision manager or, where this does not apply, to:

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