



Bond Pearce



February 2012

Wealth Managers Newsletter

We recently attended an FSA seminar on Wealth Managers at Canary Wharf to discuss the findings of last year's FSA review of Wealth Managers and the forthcoming visits the FSA is going to undertake. For clarity, a Wealth Manager is a firm which manages client money either on an advisory basis or under a discretionary mandate.

In last year's review, 14 out of 16 firms failed the FSA's visit and posed a 'medium to high risk' of client detriment. 79% of the files reviewed failed assessment and 67% of the files reviewed had significant shortfalls in the way risk and the client's objectives were documented.

The areas of concern which the FSA highlighted as part of the review were:

- an absence of 'know your customer' information
- out of date client information
- an overall failure to obtain sufficient client information to allow advice to be given, in particular client knowledge and experience and client objectives
- inadequate risk profiling
- out of date risk profiling
- client classifications not being implemented correctly.

The FSA also found inconsistencies between the client's portfolio and their attitude to investment risk, objectives, investment time horizon and the agreed investment process.

Client information

The FSA gave us an example where one file checked had a print out of a Wikipedia page as the 'know your customer' information, as the client was well known!

The FSA emphasised the need to have up to date client information at all times and this included when on-going advice or reviews are being provided as part of the service agreement with the client. The FSA made it clear that, if you do not have up to date and accurate client information, you **cannot** give advice or even review your client as the "outcome" cannot be assured as being accurate.

It also reiterated that the Suitability Report cannot be used as a Fact Find. There should be nothing in the Suitability Report unless it is recorded elsewhere in the Fact Find or meeting notes. The FSA expects you to "really know" your client and be able to prove it.

When assessing client files, the decision the assessor makes will be dependent on the client file information. The assessor will not know the client and can only make a decision based on the facts presented. A Fact Find will only record hard facts; they should **always** be supported by meeting notes including specific notes regarding investment risk. The FSA reiterated that you cannot have "suitable or accurate outcomes" if your client information is not up to date.

Client's knowledge and experience

Where there is investment advice being given, the client's knowledge and experience to invest in the recommended area must be demonstrated in the client information. This includes, where necessary, not just existing investments but past investments in complex areas, such as VCT, EIS, ETF. This then supports your advice as you have evidence that the client has experience, good or bad, of this type of investment.

COBS rules require you to detail the client's knowledge and experience, therefore, do not rely solely on the Fact Find and risk questionnaire; add detail where appropriate to support your advice. The rules state that your client file must demonstrate that the client has "the necessary experience and knowledge in order to understand the risks involved". Furthermore, the rules require you to document the "client's knowledge and experience in the investment field" and includes "the type of product or transaction envisaged, including their complexity and the risks involved".

Attitude to investment risk

It should be clear in the Suitability Report whether the risk profile of the client is for the whole of the portfolio or for just the investment amount in question.

The FSA made it clear that a poor attitude to investment risk questionnaire and poor questions result in poor and possibly inaccurate risk outcomes. Therefore, you should review the risk profile questionnaire or system you use; are the questions easy to understand? Can you prove the client has understood the questions? Is the outcome correct?

If you use a scoring system is it fair with the correct weighting given to the questions and the outcomes? The FSA is concerned with some risk profiling tools which have an unhealthy weighting towards certain asset classes such as property. All weightings and scores should be measurable, clear and unbiased.

It is important that you do not rely totally on the questionnaire as they all have limitations. Use it as one of your available tools, discuss the outcome with the client, ask questions and write the answers down. What is also important is can you prove the client has understood the questions and that the outcome is correct? This can be covered in the supporting notes.

The FSA also pointed out that, in its opinion, a risk profiling tool must include as result of there being 'no risk'.

'Capacity for Loss'

In all of the outcomes it is important that the client's expectations are managed. Therefore, if they are willing to accept loss, how much and over what time scale has it been agreed? One year? Two years? Seven years? This needs recording in your notes and will also help protect you in the event of a complaint.

The FSA made it clear that advice and recommendations cannot be given unless there is an accurate assessment of the client's attitude to investment risk and their "capacity for loss".

Therefore, when establishing the capacity for loss the client is willing to take, do not rely solely on the questionnaire. Ask questions about loss, their experience of loss (how did they feel?) and write the answers down even if it is going over the loss questions in the questionnaire as this proves understanding. How much loss can the client sustain without making a substantial impact on their life and circumstances?

The FSA is looking for individual notes to support these discussions, not relying on one or two questions in the risk questionnaire.

Risk descriptions

When deciding on the risk rating and descriptions of the funds you have researched you need to be able to prove that:

- they are accurate
- they can be measured – if someone challenged you, could you explain the due diligence and decision process?
- they are consistent
- they are reviewed
- they are clear - what is a "balanced" or "medium" risk profile? How do you explain this?
- they match your client's expectations and understanding
- it is all recorded for your own protection.

The FSA would like to see firms risk rate the funds they are recommending and tie them in with the client's risk profile. As firms need to conduct research into the funds they are recommending and applying them to client's objectives, risk rating funds should be part of this research. This should always be continually reviewed.

"Product Risk Migration"

This is where a fund, due to various pressures (economic, environmental, geographic, legal etc) changes the format of the fund which was originally researched. Therefore, funds should be regularly researched and up date to make sure they are still suitable and appropriate for your clients, your model portfolios and your investment philosophy.

Asset allocation

Again, the FSA has seen an over reliance on risk tools to recommend asset allocation, without taking the client's individual needs and objectives into account. If you are going to solely rely upon a risk tool, then make sure it has been carefully researched and quantified and it matches your business model, investment philosophy and model portfolios.

Model portfolios

Where firms use model portfolios the FSA does not want to see clients placed in the nearest model to their risk profile outcome. In some of the firms reviewed last year, it found that clients' attitudes to investment risk were not consistent with the model portfolios they were placed into and it was not clear how they matched.

One area of concern was the "time Horizons" agreed with the client and how they affected the attitude to investment risk and ultimately how the model portfolio was allocated. This has to be clear in all cases because if you are ever challenged, following a complaint or an FSA visit, the client file needs to clearly demonstrate the decision process, based on the facts and how the outcome was decided.

When re-balancing portfolios it is also important to consider all those clients within the portfolio and the effect the re-balancing will have on them, their risk profile, objectives and time horizons. Therefore, decisions to change portfolios must detail the effects on the portfolio and the effect on the clients within it.

Where firms use model portfolios, the FSA expects them to have the ability to create a bespoke portfolio where none of the models is suitable or appropriate. All portfolios should be individual and personal. Obviously some are going to be the same as other clients, but if you are ever challenged you need to be able to demonstrate why the portfolio has been recommended, why it is suitable and appropriate for that client and how it will meet their objectives over the agreed time horizon.

All model portfolios should be regularly reviewed and changed if necessary, all of which should be fully documented. Also, where a client's needs, objectives, risk profile and time horizons change, there should be changes made to the portfolio, where appropriate, so you can always show it is in the client's best interests.

Client understanding

This is an important element of protecting your firm. Can you prove, as far as you can, that the client has understood the risk rating, the model portfolio recommended and the reasons for the advice? Do they understand the "volatility of risk", risk and reward, the risk of the funds recommended, the term, the model portfolio etc? All of these are important in detailing client's understanding of the advice and recommendations. Again, notes on investment discussions will help here.

Benchmarking

Where firms use benchmarking to measure performance they must ensure that the reports to clients, whether compulsory reports under COBS, interim reports or reviews, must include the benchmarking and that it must be:

- clear
- understandable
- relevant
- accurate
- measurable

With this information, clients can make an informed decision on the performance of the firm in managing their money compared with the benchmark being used. The FSA considers this information to be an important tool for clients to use in monitoring their investments as well as their adviser.

Counterparty risks

Where funds have counterparties, in particular Absolute Return funds, the FSA expects to see in a firm's research full due diligence of the counterparty including this firm's financial position and strength.

Systems and Controls

The FSA expects to see that a firm's systems and controls are up to date, functioning and fit for purpose. They should include regular reviews of investment partners, model portfolios, research tools, attitude to investment risk questionnaires and follow the firm's T&C plan as well as having a detailed compliance plan.

We have been emphasising for many years the need to support your Fact Finds and attitude to investment risk questionnaires with detailed notes to support your 'know your customer' information. The notes do not have to read like "War and Peace"; they need to be short, to the point and if possible quote what the client has said. They should always be dated and "signed", by hand or electronically.

Within your systems and controls there should be file assessments which check the client information. These should be up to date at all times, especially before giving reviews, and include notes supporting the Fact Find and the risk questionnaire discussions you have with the client.

Senior Management

The FSA made it clear it will hold Senior Management and those holding 'Significant Influence Functions' (Controlled Functions 1, 2, 3, 4, 8, 10, 11, 28 & 29) responsible for failings in compliance and T&C. Recent events have shown the FSA's stance on firms which fail to reach the required standards; it will fine and ban individuals.

It also made it clear that it would not expect Senior Managers who are also involved in giving advice having poor T&C assessments, especially client files. If these individuals are failing their assessments, the culture in the firm is likely to be wrong. It expects Senior Managers to lead from the front and to set the standards for the rest of the firm.

Key Contacts

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