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Compliance in Asian Wealth Management Forum

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FSA Wealth Management Review

- Conducted in 2010 following pension mis-selling prosecutions
- Guidance and continuing reviews 2011-2013
- 16 firms – 4 posed high risk of detriment to customers
- 79% of files had high risk of unsuitability or suitability could not be determined
- 67% of files reviewed not consistent with
  - firm's house models
  - client's documented attitude to risk
  - client's investment objectives

SFC Thematic Inspection

- Inspections of selling practices of 10 wealth managers;
  - Variety of products
  - All firms used in house questionnaires

- Main findings were deficiencies in;
  - Management oversight, training and compliance monitoring
  - Suitability assessment process
  - Use of disclaimers and signing of declarations
  - Compliance with the new Code of Conduct for Persons Licensed by or Registered with the SFC
  - Eligibility verification of Professional Investors.

Client Risk Attitude

- Not properly account for all information relevant to assessing risk customer is willing and able to take;
  - Not take appropriate account of clients' capacity for loss
  - Capacity for loss means customer's ability to absorb falls in value of their investment
  - Assess risk that loss of capital could have materially detrimental effect on standard of living
  - Recognise risk that inflation can erode value of capital
  - Fail to identify customers suited to cash deposits as unwilling or unable to accept risk of loss of capital
  - Fail to identify customers who are better off to reduce debt levels

Risk Practices

- Good practice
  - Firm used one process to assess customer's attitude to risk and separate process to assess capacity for loss so both appropriately considered in suitability assessment

- Poor practice
  - Customer picked number on scale of 1-10 from low to high risk. No certainty customer and firm had same interpretation of level of risk number represents
  - Methodology included use of risk-profiling tool but failed to filter out customers unwilling to risk capital loss

Questionnaires

- Problems with client questionnaires
  - Poor question and answer options
  - Over-sensitive scoring or inappropriate weighting to answers.
  - Inappropriate interpretation of customer responses
  - Invitations to customers to select option they most agree with
  - Middle answers seen by customer as neutral not middle risk appetite

- Good practice
  - Provide clear and balanced guide to investment risk for customer in advance of assessing risk profile.
  - Summary of process for assessing risk customer willing to take

Poor Questions

With the money you have to invest, would you select:

(a) a product where there is very low risk of losing your money and the return is 5% pa on average; or

(a) a product where you could lose up to 15% in a year and the return is 10% pa on average; or

(b) to split your money between the two products?

"*This question is complex, assumes high level of mathematical and financial ability, and assumes that all customers will be able to identify an accurate reflection of their preferences in the three options provided*.

Poor Questions

When do you need to get back the money you invest, or start receiving an income from it?

(a) 1-4 years
(b) 5-10 years
(c) Over 10 years

“This question asks two questions in one – the customer might need income from the investment immediately and capital return at a later date.”

Poor Questions

Placing some of my money in risky investments is something I like doing;

(a) Yes
(b) Sometimes
(c) No

"*This question assumes investment experience and fails to quantify the amount of risk or money involved.*"

Option to answer 'neither yes or no'

- Middle weighting attributed to these answers
- Customer choosing this given risk profile in middle of categories
- Inaccurate assessment of risk as answer was 'non-answer' not willingness to take level of risk attributed

Risk Profiling Tools

- Reviewed 11 risk-profiling tool and 9 had weaknesses which could lead to flawed outputs

- Responsibilities when using tools
  - Firms not understand how tools work
  - Tool providers must provide support and information

- Good Practices
  - Regular management reports on results of risk-profiling tool, how results distributed across different risk categories comparison to what would be expected given firm's customer base
  - Information on numbers of customers with final risk categorisation different to that indicated by tool

Risk Profiling Tools

- Good Practices

  - Tool automatically maintained record of risk profiles for each customer and date of each assessment and prompts firm to consider if update needed

  - Tool had two stage approach to risk-profiling so adviser must discuss provisional rating with customer and record customers views on rating

  - Guide from provider included tips for use of risk profiler and events in customer's life indicating need to re-evaluate risk profile

  - Guide from provider warned adviser not rely solely on outputs of risk profiler but validate it with customer discussion.

Risk Profiling Tools

- Poor Practices

  - Tools that aggregate pieces of information from suitability and risk assessment into single automated output

  - Effect of weighting different pieces of information to single output means one answer could drive output: e.g. age or experience

  - Tool had large number risk categories so firm added descriptions to each categories for customers. Firm did not understand assumptions used in the tool description attributed not correctly reflect risks customer exposed to

Risk Category Descriptions

- Badly defined risk categories
  - Several risk categories had investments with different levels of risk but each described as suitable for customer willing to take ‘reasonable risk’
  - Categories contained vague language eg ‘reasonable’, ‘steady’, and ‘moderate variation’ for level of risk and potential for loss
  - Categories with emotive or judgemental connotations such as ‘progressive’, ‘risk aware’, ‘realistic’ and ‘motivated’

- Good practice
  - Categories with broad definitions and brief sub-sections with explanatory charts of hypothetical returns and bullet points
  - Attempted to explain risk in different ways and text and visual representation engage different customers

Risk Categories

- Problems found
  - Extremely wide categories that capture customers across a broad spectrum of views
  - Gap between risk profiles of different categories

- Poor practice
  - Large number of categories but large gap between risk levels in adjacent risk categories.
  - One risk level allowed no equity investments but adjacent level allowed for over 50% in equities.
  - No category for customers want intermediate amount in equities

Risk vs Volatility

- Model portfolios and asset-allocation tools using volatility as sole measure of risk

- Consider other risks before making recommendation
  - Inflation risk
  - Liquidity risk
  - Risk arising from lack of diversification
  - Specific features of product: e.g. structure or counterparty risk
  - Assets not traded daily or difficult to value or appear to have low volatility are not low risk

Matching Risk and Needs

- Action if customer's needs conflict with level of risk customer is willing and able to take;
  - Detailed discussion with customer
  - Draw attention to mis-matches in investment objectives, financial circumstances, risk tolerance and capacity for loss
  - Explain implications of alternative trade-off decisions – saving more, spending less, retiring later, taking more risk
  - If not sustain potential loss of higher-risk strategy explain higher return cannot be met
  - Mechanism to override risk category if needs not met by selection associated with confirmed risk description
  - Review suitability of investment requiring higher level of risk than originally identified

Suitability

- Inability to demonstrate suitability
  - Absence of basic KYC information or out of date information
  - Inadequate risk-profiling
  - Not implementing client classification requirements;
  - Lack of record of clients' financial situation (assets, source and extent of income, financial commitments)
  - Failure to obtain sufficient information on client knowledge, experience and objectives

- Risk of unsuitability arose from
  - Inconsistencies between portfolios and client's attitude to risk
  - Inconsistencies between portfolios and client's investment objective, investment horizon and/or agreed mandate.

Poor Results from Asset Allocation

- Recommended customer invest 100% of their personal pension in one property fund;
  - Customer wanted low risk less-volatile investment
  - Not to consider liquidity risk or risk of relying on performance of single asset class in single market

- Limited product range for advisers for lower-risk customers;
  - Result was recommendations for single product with single underlying asset type if customers wanted low risk
  - Unsuitably high concentration of customer's investment in one asset class

- Good practice;
  - Challenge cases if auto generated investment selections seem unsuitable for customers

Good Investment Selection

- Good Practice;
  - Firm had number of standardised initial asset-allocations
  - Adviser could change some allocations to individual customer circumstances
  - Further changes sign-off meaning adviser considered if each investment selection in best interests of customer

Poor Investment Selection

- When advisers recommended pensions, firm obliged them to recommend discretionary management service;
  - Advisers not consider adequately suitability of recommendation for individual customers; or
  - Not recognise this investment approach not appropriate for all customers.
- Inconsistent with risk description;
  - Customer in risk category described as having ‘reasonable proportion in with-profits and managed funds and a very small part in higher risk funds’ so advice to invest more than 50% in emerging market funds inconsistent
  - Risk description noted ‘very little in managed funds’ so advice to hold 100% in a balanced managed fund inconsistent

SFC Suitability Failures

- Recommended complex high risk unauthorized fund to clients which included elderly individuals and retirees;
  - Not show assessed all aspects of clients circumstances (eg investment horizon)
  - Unable to show adequate understanding of fund and unlikely could have explained product properly
  - Not present balanced view to clients emphasising only good points but not its disadvantages and downside risks

- Sold to retail customers unauthorized fund;
  - Target investors specified by manager as institutional investors

Product Selection

- Must ensure sufficient understanding features and risks of investment selection;
  - Not assume fund whose name appears to match risk category is suitable
  - Underlying asset selection must be suitable for customer
  - Fund labelled 'balanced' may not be suitable for customer with 'balanced' attitude to risk
  - Depend on content of fund and investment strategy
  - Adviser may have different concept of 'balanced' to fund manager
  - Different types of low risk products - money market 'cash' funds vs savings deposit accounts
  - Risks of complex products include nature of underlying risks of assets and markets

Product Selection

- Good practice
  - Internal experts in specific subject take responsibility for research and due diligence before feeding analysis into firm's research
  - Regular rotation of expert areas to maintain competency
  - Source independent reviews of product and reviewed similar products to understand how product compared with others

- Poor practice
  - Over-reliance on provider information when researching suitability of product for client base.
  - Gaps in provider's information so firm failed to understand risks of non traditional assets in product and inappropriately rated product lower risk

HK Product Classification

- All bonds above investment grade and all funds with risk rating of 3 suitable for all clients;
  - Products have unique features, structure and risks.
  - Cannot assume particular type of product suitable for all clients
  - Match risk profile of products to client's personal circumstances
- Calculate amount of proposed investment as % of client's net worth;
  - If % lower than specified threshold exposure considered acceptable even if risk rating of product higher than client's risk profile.
  - Failed to consider to risk of products already in portfolio

SFC Product Suitability

- Complex funds
  - Incorrect assumptions about use of derivatives in funds

- Failures detected
  - Not all firms did due diligence on SFC authorised funds
  - Reviewed reputation, track record and financial standing of fund houses only
  - Diligence on funds limited to information on fund platform not independently checked
  - Use of risk ratings for funds from research company based on 3 year annualised volatility without independent due diligence
  - Inadequate records of assessments done

RBC and Product Suitability

- SFC fined RBC Investment Management HK$4 million in relation to provision of investment advice to clients on non-SFC authorized funds from Nov 2006 - Jul 2008;
  - Not provide adequate guidance to staff on conducting due diligence on funds before making investment recommendations
  - Relied on Singapore office to conduct due diligence on investment products but no record of due diligence & not aware of scope and extent
  - Not provide adequate practical guidance to RMs in providing investment advice or recommendations.
  - Not have any measure for overall risk of investment products sold
  - RMs not ensure advice provided would best fulfill clients' investment objectives

RBC and Product Suitability

- RMs not record or document product suitability assessment undertaken to demonstrate that RBC was reasonably satisfied that investment products recommended suitable for client
- Not adequate procedures requiring RMs to document investment advice and underlying rationale and provide copy to clients
- RBC's supervision of RMs not effective in ensuring recommendations to clients suitable and reasonable

- Failed to ensure investment recommendations based on thorough analysis and reasonable in circumstances
- RBC's breaches prejudicial to interest of investing public
- Repurchase offer, fine and special reviewer appointed

Professional Investors

- Problems in countries where threshold is not purely monetary
- Means test
  - Not specify acceptable method to establish investor worth
  - Self certification?
- Person to meet requirements at relevant date
  - Date of document issue vs call made vs offer made
- Do you have to establish worth prior to marketing?
  - Contractual question as to when offer is made
- For firms restricted to dealing with professionals
  - Do regulators look through to investor education efforts etc.
- Client opt in / opt out provisions

CIC Investor Services

- CIC publicly reprimanded and fined $4 million

- SFC identified that CIC failed:-
  - to evidence clients had met requisite requirements under Securities and Futures (Professional Investor) Rules
  - to adequately assess investment experience of its clients as required under Code of Conduct
  - to obtain signed declarations from clients who agreed to be treated as professional investors as required under Code of Conduct
  - to maintain adequate documentary records of investment advice given to clients

CIC Investor Services

- Specific issues in 420 clients:-
    - No custodial or accounting statements as to value of portfolios
    - < 50% of clients classed as PIs not meet HK$8 million test
    - Treated clients as PIs in all products
    - Only 10 clients meet requirement to have 40 transactions p.a. in derivatives (in fact in any products)
    - <90% did not have 2 years of trading experience
    - Still classified clients as having “high” level of experience
- Letter to all clients seeking agreement to be treated as PI
    - CIC claims 184 clients responded
    - Only 4 documentary agreements located
- Not met requirements of 2005 “Selling Practices Note”

Julius Baer Hong Kong

- SFC reprimands and fines Julius Baer HK$3 million

- Julius Baer licensed to provide services only to PIs failed to
  - Take adequate steps to identify clients as PIs before treating them as such
  - Conduct annual confirmation
  - Maintain adequate written records of investment advice given to clients

"The difference between professional investors and ordinary retail customers is a profoundly important one. Firms that do not classify customers properly, in strict compliance with the requirements, impose undue risks on those customers. The SFC will not hesitate to take deterrent action in these cases," said Mark Steward

Management and Oversight

- Inadequate management oversight
  - Transactions involving risk mis-match not detected by Head of Sales solely responsible for directly supervising selling activities of 70 sales staff
  - Detection failure attributable to inability of single supervisor to exercise effective supervision over large number of sales staff

- Inadequate documentation
  - No guidance to sales staff to document rationale underlying investment recommendations to clients
  - No written guidelines on how to conduct suitability assessments
  - Individual investment transactions subject to review and approval by supervisory staff but no clear guidance to them of approval criteria

Training

- Possible for smaller firms to train sales staff in less structured or formal manner via day-to-day supervision but must ensure adequate training provided;

  - New product training not compulsory for sales staff distributing product
  - Attendance at weekly training below 40% and some sales staff not attend any training in 12-month period.
  - Firm not demonstrate adequacy of training as no record of frequency and types of training provided and staff attendance

Compliance Failures

- Insufficient compliance monitoring;
  - Ceased regular compliance monitoring due to lack of resources;
  - No controls to ensure that information required to be obtained from clients collected in accordance with internal policies;
  - Missing or inconsistent details in client information forms not been identified for follow-up action;
  - No procedures to monitor non-compliance with internal policies requiring sales staff to obtain updated clients' profiles;
  - No pre-trade or post-trade review to ensure sales staff followed suitability policies when making investment recommendations;
  - Sales team head approved own transactions and had authority to review and approve client orders from team and earned commission. No compensatory safeguards.

Documentation Failures

- Record keeping must ensure against loss of client information;
  - Sales staff kept own notes regarding client's circumstances and subsequent changes,
  - Not keep copy of information as part of firm records

- Client agreements / account opening documentation contain clauses restrict investor protection measures;
  - Firm not obligated to forward any notices or documents received for client investments
  - Client's duty to obtain copy of fund offering documents
  - When clients signed risk profiling form also acknowledged firm has no responsibility for assessing if products suitable

Documentation Failures

- Client agreements / account opening documentation contain clauses restrict investor protection measures;
  - If client transacts in high risk products must sign declaration to that product purchased without recommendation or solicitation
  - If client ticked it had not received investment advice client automatically confirmed made own investment decision, read product literature and competent to judge suitability of product
  - Design of declaration faulty as option is a multiple question with only one affirmative answer

Selling Unauthorised Funds

- SFC commenced criminal proceedings against Pacific Sun Advisors and director Andrew Mantel
  - 4 counts of issuing advertisements to promote CIS without SFC authorization
  - Nov / Dec 2011 firm issued advertisement on corporate website promoting Pacific Sun Greater China Equities Fund
  - On 2 Nov 2011 firm issued advertisement regarding the launch of the same CIS to public by email

- Firm's defence:-
  - Copy of a press release about new fund launch
  - Disclaimed as only suitable for professional investors
  - Email only to existing clients / investors in other fund

Complaint Handling

- SFC fined Merrill Lynch (Asia Pacific) Ltd $3.5 million for
  - Failing to take adequate steps to properly handle complaints of 11 clients in 2008 before rejecting their complaints
  - ML made inquiries into each complaint, but did not investigate all relevant circumstances and some complaints incorrectly rejected

- Clients defrauded by Joyce Hsu Ming Mei (former LR) convicted of 20 counts of theft complained she;
  - Misrepresented investment products as principal guaranteed;
  - Conducted unauthorized transactions / loan drawdowns / fund transfers in their accounts; and
  - Provided false account statements.

UK on Cost Contributions

- Cost contribution from provider for distributor training / conferences / seminars may be prohibited inducement;
  - Potential to impair compliance with distributor's duty to act in best interests of the client and not enhance quality of service to client
- Payments to distributor for assisting in promotion of provider's investment products;
  - Payments to reflect costs incurred by distributor in promotion,
  - Distributor's assistance in promoting products must lead to enhancement of quality of service to clients.
- Payments to distributor for IT development to operate software supplied by provider;
  - Necessary to operate software or generate equivalent cost savings

Inadequate Disclosure of Fees

- SFC reprimanded Société Générale for failings in internal controls in Wealth Management activities;
- SG to reimburse affected customers full value of fee together with interest (US$11 million);
- 3,000 transactions from 2003 – 2006;
  - Customers paid or received different price for OTC products from actual price transacted for them by SG
  - Difference retained by SG as a fee
  - Fee variable and in some cases excessive
  - SG not disclose fee to customers
  - Fee not disclosed as commission in contract notes
  - Inadequate conflicts and internal control procedures

FSA Review of Selling Bonus

- Review of 22 firms' financial incentive schemes;
  - Most incentive schemes likely to drive people to mis-sell and risks not being properly managed
  - Failing to identify how incentive schemes encourage staff to mis-sell and not properly thought about risks or turning blind eye
  - Failing to understand own complex incentive schemes
  - Relying on routine monitoring of staff rather specific features of their incentive schemes
  - Sales managers with clear conflicts of interests - responsibility to manage conduct of sales staff but earning a bonus if team made more sale
  - Not doing enough to control mis-selling in face to face situations

Poor Incentive Schemes

- First past the post' system where first 21 sales staff to reach target earn 'super bonus' of £10,000;
- Basic salaries for sales staff move up or down by more than £10,000 pa depending on how much they sold;
- Excessively incentivised one product over another so clear risk advisers sell product that earned them more;
- Sales staff earn bonus of 100% of basic salary for sale of loans and PPI, but bonus was only payable to those who had sold PPI to at least 50% of their customers.

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Suitability and Investor Testing

- If you have not recently assessed suitability of your client files:-
  - Sample meaningful number of client files
  - Assess whether files have relevant, meaningful, accurate and up-to-date client information
  - Consider depth, breadth and quality of client information
  - Are client portfolios and current holdings in client portfolios suitable based on documented client information you hold
- Check on proof of clients being accredited.

Review Wealth Management Tools

- Key points to check:
  - Is it suitable for use with your customer base?
  - Do you understand how it works, so you can interpret and evaluate results when applied to individual customers?
  - To what extent will it help you meet regulatory requirements?
  - Can you mitigate its shortcomings or limitations?
  - For asset-allocation or fund-selection tools do you understand the products, market and asset risks for these investments?

Review Third Party Providers

- Does your agreement with third party providers cover:-
  - Performance pledges: i.e. it will perform as described
  - Providing supporting information to you
  - Ensuring the information is clear and accessible
  - Ensuring you are kept updated on system changes
  - The scope of tool including situations it is not designed to cover
  - Any limitations of the tool, including circumstances for which should not be used
  - Assumptions relevant to its use: e.g. about the target market

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