

Financial Services Authority

Unregulated Collective Investment Schemes:

Project Findings

July 2010

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Annex 1: Project methodology

1 Executive summary

Introduction

- 1.1 In 2009 our supervision and TCF¹ assessment work identified issues surrounding the sale of unregulated collective investment schemes (UCIS) by small firms. Our main concerns included:
- firms' lack of awareness of regulatory requirements for UCIS;
 - firms' lack of understanding of the UCIS market and their risks; and
 - UCIS promoted and recommended to customers² who were not eligible for this type of investment.
- 1.2 Currently, six small firms that have been promoting and recommending UCIS to their customers are being investigated by our Enforcement and Financial Crime Division.
- 1.3 In October 2009 we informed all small financial adviser firms, via the Regulatory Round-Up, that we were about to conduct a project focusing on UCIS. We stated that we would look at firms' financial promotions and advice processes for the sale of UCIS and would assess whether firms are complying with our rules and regulations and providing fair outcomes for consumers. We also said we would start our work with an online questionnaire and subsequently conduct a further review.
- 1.4 This report summarises the findings from our project.

1 Treating Customers Fairly

2 Meaning of 'customer' here includes 'potential customer'.

Scope of the project

- 1.5 The main focus of our project was on the eligibility of customers and the quality of advice when firms promote and recommend investments in UCIS. We reviewed firms' UCIS business written during the period 2008 and 2009 ('the relevant period'). We did this by reviewing financial promotions and advice to individual customers, by assessing firms' systems and controls to ensure suitable advice is provided and customers eligible for the promotion of UCIS are treated fairly. We included within the scope of our project any products that had a UCIS as an underlying investment.
- 1.6 We initially undertook a high level, desk-based review of 66 independent financial adviser (IFA) firms that were selected as a result of our online questionnaire. We then narrowed this down to a short-list of 14 firms for whom we undertook a full review. See the Annex for details of the project methodology that we used.

Key findings

Regulatory requirements for UCIS

- 1.7 Firms were unaware of the statutory restrictions on the promotion of UCIS to the general public. Therefore, they may have promoted UCIS where this is prohibited.

Financial Promotion of UCIS to retail customers

- 1.8 In total, we reviewed 131 UCIS transactions for 120 customers. During the relevant period, 73 different UCIS were promoted and/or recommended to these 120 customers. In the majority of files (119 cases) the firms promoted UCIS. There were 12 cases where UCIS was not promoted (discretionary portfolio management service).
- 1.9 In 90 (or 76%) out of the 119 cases where UCIS were promoted, we found that the firms failed to use the available exemptions under the PCIS Order³ or COBS⁴ 4.12 before they promoted UCIS. This was across 88 customers.
- 1.10 Although in some of these cases the firms could have applied exemptions, there was little or no evidence gathered and documented by the firms before their promotion of UCIS to support these exemptions.

3 The Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes (Exemptions) Order 2001 (SI 2001/1060) (as amended)

4 The FSA Conduct Of Business Sourcebook

- 1.11 We identified that non-compliant promotion of UCIS was spread evenly across the sample, with 11 (or 78%) out of the 14 firms accounting for 86 (or 96%) cases of non-compliant promotion. Although, our sample of firms and files reviewed was small, the fact that non-compliant promotion of UCIS were identified across all firms in the sample leads us to believe that these results represent those firms that are promoting UCIS to their customers across the sector. The most common reason for this non-compliance was found to be the firms' lack of knowledge and awareness of regulatory requirements for the promotion of UCIS, as well as a lack of understanding of what is a 'financial promotion'.

Quality of advice

- 1.12 Firms have sold UCIS to customers for whom they may not be suitable.
- 1.13 We reviewed the 131 UCIS transactions from a position that the firms could have applied exemptions under the PCIS Order or under COBS 4.12 had the firms known about and fully understood the regulatory requirements for the promotion of UCIS. From this position, out of the 131 UCIS transactions reviewed, we assessed 24 (or 22%) UCIS cases as those where the firms failed to demonstrate suitability of advice and 57 (or 52%) as unclear due to lack of adequate know your customer information being obtained and retained on file (see paragraph 4.6 below).
- 1.14 The cases where the firms failed to demonstrate suitability of advice were spread unevenly across the sample, with four firms (or 28%) accounting for 17 (or 71%) such cases. The most common reason for this failure was found to be inadequate consideration by the adviser of the high proportion of the customers' overall portfolio which had been invested in UCIS. This appeared to misbalance the risk tolerance within their portfolios and therefore did not match the customers' attitude to risk (ATR) (in 24 cases).

Regulatory actions

- 1.15 As a result of our findings, in particular the level of non-compliant promotions and failure to demonstrate suitability of advice:
- We invited 11 firms to vary their permissions so they cease advising on, arranging or otherwise promoting, any UCIS or any other scheme or product which involves investment in such unregulated schemes, to any of its customers, until a full review has been completed by a skilled person and any required remedial actions undertaken.
 - We also required these 11 firms to appoint a skilled person under Section 166 FSMA to review their UCIS promotions. This may also result in firms being required to pay redress to customers.

- We required four of these 11 firms to appoint a skilled person under Section 166 FSMA to also conduct a review of their quality of advice. This may also result in firms being required to pay redress to customers.
- We are discussing a number of firms with the Enforcement and Financial Crime Division with a view to potential referral in relation to issues raised by this work, primarily due to concerns of non-compliant promotions and that customers that may not be eligible for the promotion of UCIS have been promoted UCIS, as well as the firms' failure to demonstrate suitability of advice provided to customers as a result of training and competence failings and inadequate systems and controls at the firms.
- We required five firms⁵ to carry out past business reviews of the UCIS advice they have given. This may also result in firms being required to pay redress to customers.

Good and poor practices

- 1.16 We were disappointed that our project identified only two firms out of our sample of 14 that appeared to adequately understand, and had adequately implemented, the regulatory requirements for UCIS business where we also identified no concerns with the advice that they had given. In contrast, we have identified a wide range of poor practice at the other 12 firms that we reviewed. We have set out some examples of good and poor practice in relation to the promotion and selling of UCIS in a separate report.⁶

Key risks

- 1.17 Our project findings support all the areas of concerns that we initially found in the few firms that we reviewed in 2009. Our concerns as set out in paragraph 1.1 above therefore remain. In particular, as firms increasingly make the transition towards promoting and advising on alternative investments, our three main concerns are that firms do not adequately consider:
- **Customers' eligibility for the promotion of UCIS:** Firms should ensure they comply with all of the applicable regulatory requirements in respect of promotion of UCIS to the general public and, where this is not the case, they should take appropriate action (including remedial). Where firms have been advising retail customers to invest in UCIS without explicit regard to the statutory restrictions, they should check with their professional indemnity (PI) insurer whether their PI cover remains valid.

⁵ We did not require five firms to review files for the suitability of advice; this includes one firm that only provides non-advice services on UCIS.

⁶ UCIS Good and Poor Practice Report in www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/ucis_report.pdf

- **Quality of advice (suitability):** Firms should review their selling practices to ensure that suitable advice on UCIS is delivered.
- **Poor risk management and oversight:** Firms should review their systems and controls especially in relation to financial promotions (including checking when and whether a customer is eligible for the promotion of UCIS) and customer's risk profiles.
 - o Firms are reminded that when it comes to promoting and advising on investments, they may be doing both in the course of the same communication (whether oral or written) and the effectiveness of their systems and controls will be essential in ensuring compliance with their regulatory obligations. Firms should seek professional advice if they are unsure about their obligations.
 - o Firms should consider temporarily ceasing promoting, advising on and/or arranging further UCIS transactions, including transfers from one UCIS to another, until they have reviewed and aligned their UCIS financial promotion processes and practices to the requirements under section 238 FSMA⁷, the PCIS Order and COBS 4.

Next steps

- 1.18 We have produced a Good and poor practice report to help firms understand our expectations when introducing UCIS to their advice process.
- 1.19 Firms can find more information on this subject in our summary UCIS Factsheet.⁸
- 1.20 More detail on our wider view on promoting UCIS can be found at <http://www.fsa.gov.uk/pages/Doing/Regulated/newcob/faqs/comms2.shtml#cis>
- 1.21 We do not intend to extend this project to other firms at this time, but we will continue monitoring and assessing how firms promote UCIS and provide investment advice on UCIS. This will form a supervisory priority going forward. We will continue monitoring developments in this market and the results of our supervisory activities and, if necessary, will consider whether further regulatory action is required.

⁷ The Financial Services and Markets Act

⁸ UCIS Factsheet in www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/ucis_factsheet.pdf

- 1.22 As stated in our Policy Statement March 2010,⁹ ‘we do not expect the widening of the scope of products covered by the new definition to lead to the additional products being sold in greater numbers if this is not appropriate. However, products other than packaged products are already being recommended to retail clients in ever increasing numbers. Our aim is to ensure that, when these products are being recommended, they are captured by our new rules, including those on adviser charging. It would not be a desirable outcome if some products marketed to retail clients were subject to the adviser charging rules, while others were not.’
- 1.23 As a result of our findings (see paragraph 2.6 below) and as part of our continuous engagement with compliance consultants (and firms’ compliance officers), we will provide them with more guidance regarding issues identified during this project work.

⁹ *Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules.* In http://www.fsa.gov.uk/pages/Library/Policy/Policy/2010/10_06.shtml

2 Regulatory requirements for UCIS

- 2.1 Although the main focus of our project was on firms' financial promotions and advice processes for the sale of UCIS, we assessed firms' awareness and understanding of UCIS regulatory requirements.
- 2.2 This chapter details our findings in relation to the 14 firms' compliance with UCIS regulatory requirements. We also assessed firms' financial promotions and quality of advice (suitability) provided and our findings are reported in Chapters 3 and 4.

Our expectations

- 2.3 UCIS are described as unregulated because they are not subject to the same restrictions as a regulated collective investment schemes (e.g., in terms of their investment powers and how they are run). Although the schemes themselves are not authorised or recognised, persons carrying on regulated activities in the UK in relation to UCIS (including providing personal recommendations, arranging deals and establishing, operating and managing schemes) will be subject to FSA regulation, including Handbook requirements (as in COBS).
- 2.4 There are also complex and specific requirements relating to the promotion of these schemes that stretch from the restrictions on the promotion of UCIS by authorised persons to general public under section 238 FSMA ('the restrictions'), the exemptions to the restrictions under the PCIS Order and COBS 4.12 ('the exemptions'). Separately, in determining whether a firm is doing MiFID business or not, the Article 3 MiFID¹⁰ exemptions are also relevant. We expect firms to be aware of and comply with these regulatory requirements.

Our findings

- 2.5 We found that 11 (or 78%) of the 14 firms reviewed were in breach of some or all of these requirements referred to in paragraph 2.4 above. Reasons for this included the following:
- firms were unaware of the statutory restrictions on the promotion of UCIS to the general public and therefore promoted them to their customers before satisfying themselves that the customers were eligible for the promotion of this type of investment;
 - firms did not provide adequate and clear explanations why the advice they gave in relation to UCIS was suitable for the customer's personal and financial circumstances;
 - firms did not have any T&C¹¹ arrangements for UCIS business in place to ensure their advisers were competent to do such business;
 - two firms did not investigate complaints relating to their UCIS business; and
 - firms did not supervise and monitor the UCIS advice that was provided to their customers.
- 2.6 It was also disappointing to see that some compliance consultancy firms were also unaware of the regulatory requirements surrounding UCIS. In some cases compliance consultancy firms have provided either no or inaccurate guidance to firms.

11 Training and Competence

3 Financial promotion of UCIS

- 3.1 One of the main focuses of our project was on the compliance of the firms' promotions and eligibility of customers for promotion of UCIS. We assessed this subject by:
- assessing firms' understanding of financial promotion;
 - reviewing firms' financial promotion processes and practices for ensuring compliant promotion of UCIS to eligible customers; and
 - reviewing individual customer files.
- 3.2 This chapter covers findings from the 14 firms where we undertook a full assessment.

Firms' understanding of what constitutes a financial promotion

- 3.3 When assessing the firms' understanding of financial promotion, we discussed it with firms and their selling staff, reviewed their formal procedures as well as the file reviews.
- 3.4 We rated each firm as either 'with clear understanding of financial promotion' or 'with no clear understanding of financial promotion'. Out of 14 firms reviewed, nine firms were rated 'with no clear understanding of financial promotion' and five 'with clear understanding of financial promotion'.

Our expectations

- 3.5 Section 21 'Restrictions on financial promotion' of FSMA 2000 defines financial promotion as 'the communication, in the course of business, of an invitation or inducement to engage in investment activity'; it also defines communication as 'causing a communication to be made'. Article 3 'Interpretation: communications' of the PCIS Order defines a communication

as ‘any communication by an authorised person in the course of business of an invitation or inducement to participate in an unregulated scheme’.

- 3.6 We expect firms to understand that financial promotion is a broad concept and does not solely mean communicating through a written financial promotion, such as marketing literature. It includes face-to-face discussion, phone calls, emails, advertisements, websites, presentations etc. Therefore, when communicating with a customer or a potential customer about investment opportunities that relate to or include a particular UCIS (e.g. the firms are bringing the UCIS to the customer’s attention for the first time when making their recommendation), we expect the firms to consider carefully whether they are promoting this investment to the customer.
- 3.7 We also expect firms to consider what they are actually doing and how they are bringing the UCIS to the customer’s attention. For example, if the first the customer heard of a particular UCIS was when a firm makes a recommendation, then arguably this is communicating an inducement or invitation to participate, i.e. a financial promotion.

Our findings

- 3.8 We rated nine (or 64%) out of 14 firms as not having a clear understanding of what constitutes a financial promotion. Reasons for this assessment included the following:
- failing to consider verbal communications (such as face-to-face discussions and phone calls) about a particular UCIS as financial promotions;
 - failing to consider the firms’ introduction to a particular UCIS during their presentation of the recommendation to invest the customer’s money into that UCIS (as part of the firms’ sales process) as a financial promotion; and
 - failing to consider written communications (such as emails) regarding a particular UCIS as financial promotions.

Firms’ processes and practices for the financial promotion of UCIS

- 3.9 When reviewing the firms’ financial promotion processes and practices, we considered each firm against three potentially unsuitable outcomes:
- the firms were not complying with the restrictions (see paragraph 2.4 above) on promotion of UCIS by authorised persons to retail customers nor with the exemptions to these restrictions;

- the firms failed to evidence their reasonable belief and/or their knowledge of the customers to whom they promoted UCIS in order to satisfy themselves that the customers were eligible for the promotion of UCIS (identified from the UCIS customer file reviews); and
- MiFID firms, which relied on the third parties' UCIS promotional material, failed to establish that this material complies with the financial promotion rules.

We rated each firm as 'compliant with restrictions' or 'non-compliant with restrictions'. We rated 11 (or 78%) out of 14 firms 'non-compliant with restrictions' and three (or 22%) firms 'compliant with restrictions'.

The firms were not compliant with statutory restrictions on the promotion of UCIS by authorised persons to the general public under section 238 FSMA nor with the exemptions to these restrictions.

Our expectations

- 3.10 Section 21 FSMA prevents the promotion of UCIS by unauthorised persons, unless the financial promotion is approved by an authorised person or benefits from an exemption in the FSMA 2000 (Financial Promotions) Order 2001.
- 3.11 Section 238 FSMA then precludes the promotion of UCIS by authorised persons except where:
 - there is an statutory exemption in an order made by the Treasury (see the PCIS Order); or
 - the financial promotion is permitted under FSA Rules exempting the promotion of UCIS under certain circumstances (see COBS 4.12).
- 3.12 Under COBS 4.12.1R, authorised firms may communicate an invitation or inducement to participate in a UCIS without breaching the restriction in Section 238 FSMA if the promotion falls within an exemption in the table in COBS 4.12.1R (4). The inducement/invitation must be made only to recipients whom the firm has taken reasonable steps to establish are persons in that category or be directed at recipients in such a way as to reduce, as far as possible, the risk of participation in the UCIS by persons not in that category.¹²
- 3.13 Therefore, if the exemptions are not available for a particular customer, firms should not be promoting UCIS to that customer as the customer is not deemed eligible for the promotion of UCIS.

12 COBS 4.12.1R(2)

- 3.14 When relying on exemptions, firms should check carefully that they meet all the conditions of the relevant exemption. For example, in relation to the statutory exemptions under the PCIS Order (e.g. certified high net worth individuals, certified sophisticated investors and self-certified sophisticated investors), there are a number of conditions regarding the individual wording of statements that must be obtained by the Firm prior to the commencement of its promotion of UCIS; there are also related warnings and indications that firms are required to give to investors at the beginning of the financial promotions for UCIS.

Our findings

- 3.15 We rated 11 out of 14 firms as not compliant with the restrictions nor the exemptions to these restrictions. Reasons included:
- the firms were either fully or partially unaware of the restrictions on the promotion of UCIS to general public and the exemptions on the restrictions;
 - those firms that were aware of the restrictions assumed that the restrictions do not apply to them as they were not promoting UCIS but only advising on them;
 - firms were confused as to how the restrictions and exemptions apply;
 - firms were unaware of the exemption for high net worth companies set out in article 22 of the PCIS Order;
 - firms were unaware of the definition of certified high net worth individuals as set out in article 21 of the PCIS Order;
 - firms were unaware of the amendments to the requirements for certificates for high net worth individual as set out in the revised article 21 of the PCIS Order;
 - firms were unaware of the newly introduced exemptions for self-certified sophisticated investors as set out in article 23A of the PCIS Order;
 - statements for certified high net worth individuals and self-certified sophisticated investors were only signed by the firms or the customer's accountant and not by the customers;
 - firms did not provide certified high net worth individuals and self-certified sophisticated investors with the required warning and indications as set out in the PCIS Order;
 - firms used exemptions for certified high net worth individuals and self-certified sophisticated investors as set out in the FPO,¹³ which refers to the promotion of UCIS by unauthorised persons;
 - firms failed to demonstrate the suitability of UCIS for category 2 investors as required under COBS 4.12; and

13 The Financial Services and Markets Act 2000 (Financial Promotions) Order 2005

- firms failed to demonstrate that they have undertaken an adequate assessment of the customer's expertise, experience and knowledge for category 8 investors as required under COBS 4.12.
- 3.16 As a result, we rated 90 (or 76%) out of 119 individual promotions as non-compliant with the restrictions and the exemptions to these restrictions:
- in 67 (or 56%) cases the firms failed to use any available exemptions; and
 - in 23 (or 19%) cases the firms used the available exemptions incorrectly, of which:
 - o 11 were for sophisticated investors under the PCIS Order;
 - o five were for high net worth individuals under the PCIS Order; and
 - o seven were category 2 investors under COBS 4.12.
- 3.17 In the remaining 29 (or 24%) out of 119 individual promotions, which we rated as compliant with the restrictions and the exemptions, the firms used available exemptions:
- for sophisticated investors under the PCIS Order – in three cases;
 - for high net worth individuals under the PCIS Order – in seven cases; and
 - category 2 investors under COBS 4.12 – in 19 cases.

The firms failed to evidence/record their reasonable belief and/or adequate assessment of the customer's personal and financial circumstances in order to ensure that the customer is suitable for the promotion of UCIS.

Our expectations

- 3.18 The exemptions under the PCIS Order, in particular for a self-certified high net worth individual and a self-certified sophisticated investor, allow promotions of UCIS by authorised persons on the basis of a reasonable belief that the investor is a self-certified sophisticated investor or self-certified high net worth individual. Reasonable belief pertains merely to the existence of a signed statement for the self-certified investor, which is required by the articles 21 and 23A of the PCIS Order, respectively. As 'requiring only reasonable belief of the existence of a signed statement will avoid imposing a burden of having to undertake any due diligence in order to form a reasonable belief that a potential investor qualifies as high net worth or sophisticated (i.e. is correctly certificated)'.¹⁴

¹⁴ 'Informal capital raising and high net worth and sophisticated investors. Changes to the Financial Promotion Order' Government response, November 2004. Can be found in here www.hm-treasury.gov.uk/d/Informal_capital_raising_responopt251104.pdf

- 3.19 However, if there are real grounds for the firm to believe that the investor is not sophisticated (e.g. mental capacity of the investor) then providing a statement might not absolve the firm, depending on the circumstances. In fact in such a case the burden would fall on the firm to justify how they constituted this reasonable belief. We expect firms to be able to demonstrate and justify the reasonableness of their belief in all the circumstances of the case.
- 3.20 With all the subsequent communication of the same UCIS to the same customer, we expect that this communication is made by the same person who made the first communication; and to be made within 12 months of the recipient receiving the first communication. This is set out in the article 11 of the PCIS Order. Should any further communications relate to a different UCIS or by a different authorised person or outwith a 12-month period, we expect the firms to evidence their decision to promote UCIS to that customer.
- 3.21 With regards to applying COBS 4.12 exemptions, the firms should, before communicating a particular UCIS to a customer, demonstrate they have taken reasonable steps to establish that the customer falls within a relevant category and can receive a financial promotion for a UCIS.
- 3.22 Under COBS 9 ‘Suitability (including basic advice)’ Rules, before the firms recommend a UCIS, they need to gather information about their customer in order to establish whether that UCIS is suitable for that person.
- 3.23 When making a personal recommendation or providing discretionary portfolio management services on a UCIS, the firms must meet all suitability obligations, including obtaining the necessary information regarding their customer’s knowledge and experience in relation to UCIS, their financial situation and investment objectives, to enable the firms to make a suitable recommendation.
- 3.24 To demonstrate that firms have adequate procedures in place, we expect firms to ensure they document the exemption/s on which they are relying when promoting a UCIS, and the reasons why the exemption/s apply. For example, if a firm uses exemptions in articles 21-23 of the PCIS Order the firm will need to show they have complied with the certification requirements. Alternatively, if a firm uses exemptions under COBS 4.12 the firm will need to show they have taken reasonable steps to establish that the recipients fall within a relevant category of person.

Our findings

- 3.25 Although 90 (or 76%) out of the 119 individual promotions reviewed were non-compliant with the restrictions and the exemptions to these restrictions (see paragraph 3.16 above), in some cases the firms could have applied the exemptions under the PCIS Order or COBS 4.12. However, there was little or no evidence gathered and documented by the firms prior to their promotion of UCIS in order to support these exemptions.

3.26 We identified that 11 (or 78%) out of the 14 firms gathered inadequate know your customer (KYC) information (in the majority of the files reviewed) before assessing their customers' eligibility for the promotion of UCIS. This resulted in some cases in UCIS being promoted, and subsequently recommended, to customers that were not eligible for this type of investment. Reasons for this included the following:

- firms failed to comply with the definition of sophisticated investor and/or high net worth individual by including the customers' main residence, pensions and loans as part of the customers' net assets; or by stating that the customer is not considered to be sophisticated but the firm is advising on UCIS anyway;
- firms failed to obtain certificates for high net worth individual and/or sophisticated investor as required by articles 21-23 of the PCIS Order;
- when applying COBS 4.12 exemptions, firms failed to record their decision as to why they were satisfied that the financial promotion complies with the financial promotion rules in COBS 4;
- firms gathered limited or no details of the customers' net assets and their overall investment portfolio;
- firms failed to gather the customers' knowledge and experience in investing in UCIS;
- firms' decision to introduce/promote UCIS to high-attitude-to-risk customers was based on the customers' attitude to risk, and not on their net assets or level of financial sophistication (as set out in the PCIS Order) or needs and objectives; and
- firms failed to comply with COBS 10 'Appropriateness (for non-advised services)' requirements for non-advised business.

MiFID firms relied on the 3rd parties' UCIS promotional material but failed to establish that this material complies with the financial promotion rules.

Our expectations

3.27 Where a UCIS promotion can be made, the COBS rules apply differently in relation to MiFID or equivalent third country business and non-MiFID business. Firms that are otherwise 'non-MiFID firms' need to ensure that they do not fall foul of the 'Article 3 MiFID exempt firm' requirement. For example, they will fall outside the article 3 MiFID exemption if they transmit orders directly to operators of UCIS who are not also fund managers to whom MiFID applies.

- 3.28 It is a requirement under COBS 4.10.10 R that a MiFID firm should take reasonable care to establish that the 3rd party financial promotion material complies with the financial promotion rules; and that the firm communicates this financial promotion material only to recipients as intended by the 3rd party material.
- 3.29 We expect the firms to be aware of their MiFID/non-MiFID status as well as the above requirements and the guidance in Chapter 4 of the ‘MiFID Permissions and Notifications Guide – Update’ and PERG¹⁵ 13 ‘Guidance on the scope of the Markets in Financial Instruments Directive and the recast Capital Adequacy Directive’, in particular PERG 13.5 ‘Exemptions from MiFID’ Q49 and Q50.
- 3.30 We have also published ‘*Promoting unregulated CIS – Communicating with clients, including financial promotions*’¹⁶

Our findings

- 3.31 None of the 14 firms produce their own financial promotion material for UCIS. They relied on UCIS Information Memorandum and/or other literature designed by the UCIS promoter or UCIS fund manager. Firms issue these documents to their customers.
- 3.32 Six of the 14 firms are MiFID firms and the remaining eight firms are non-MiFID firms. Most of the firms were unaware of COBS 4 regulatory requirements for MiFID firms.

15 The FSA Perimeter Guide

16 www.fsa.gov.uk/pages/Doing/Regulated/newcob/faqs/comms2.shtml#cis

4 Quality of advice (suitability)

- 4.1 We also assessed the quality of investment advice (suitability) given by firms when advising on UCIS. We assessed this by:
- reviewing individual customer files; and
 - reviewing the firms' systems and controls for ensuring suitable advice is delivered.
- 4.2 This chapter covers the findings from the 14 firms where we undertook a full assessment.

File reviews

- 4.3 When assessing the quality of investment advice, we considered that in some cases the firms could have applied exemptions under the PCIS Order or COBS 4.12 had the firms known about and fully understood the regulatory requirements for the promotion of UCIS.
- 4.4 We reviewed a total of 147 customer files across the 14 firms, of which 131 cases were UCIS cases (including 12 discretionary portfolio management cases where there was no promotion of UCIS) and 16 non-UCIS cases (as the firms reported them to us as UCIS cases).¹⁷ UCIS cases were transacted on either an advised basis (109 cases) or non-advised basis (22 cases).
- 4.5 We rated each of the 109 advised sale cases as either 'suitable', 'failed to demonstrate suitability' or 'unclear' where a clear assessment of suitability could not be made.
- 4.6 We rated 24 (or 22%) out of the 109 cases (see paragraph 4.4 above) as failed to demonstrate suitability, 57 (or 52%) cases as unclear and 28 (or 26%) cases as suitable.

¹⁷ Out of 16 non-UCIS cases, 10 cases were rated as failed to demonstrate suitability and three cases as unclear. In the remaining three cases, there was no advice given.

- 4.7 The main reasons for the firms' failure to demonstrate suitability of their advice were the following:
- the firms failed to provide the customer with all relevant, and pertinent to a particular UCIS, risk warnings prior to application being signed;
 - the firms recommended customers to invest, or transfer, a high proportion of their investment or pension portfolio into UCIS, which resulted in the portfolio's risk tolerance being misbalanced and not matching the customer's overall attitude to risk, as well as not matching the customer's needs and objectives; and
 - the firms recommended investments which did not match the customer's attitude to risk, needs and objectives, and their overall personal and financial circumstances.

The firms failed to provide the customer with all relevant, and pertinent to a particular UCIS, risk warnings prior to application being signed

Our expectations

- 4.8 Although COBS 9.4.1R only applies to regulated collective investment schemes, whether or not it issues a formal suitability report to those customers it has provided UCIS advice to, a firm has obligations under COBS 9.2.1R to ensure that it takes reasonable steps to ensure that a personal recommendation is suitable for its customer, and to obtain the necessary information to back this up. There is also a requirement under COBS 9.5.2R that a firm's records relating to suitability (which includes the information obtained) must be retained for a minimum of five years. This is in addition to the general record keeping requirements in SYSC¹⁸ 9 'Record Keeping'.
- 4.9 Where firms are unable to demonstrate the suitability of their advice, their customers are at risk of receiving unsuitable advice.

Our findings

- 4.10 We rated all the 24 cases that failed to demonstrate suitability of advice (see paragraph 4.6 above) as also inadequate on this point. Reasons for this included the following:
- failing to bring to the customers' attention that the recommended scheme is unregulated and to highlight all relevant risks of an unregulated scheme (e.g. UCIS frequently invest in assets that are less/not liquid, some UCIS

18 The FSA 'Senior Management Arrangements, Systems and Controls' Sourcebook

are geared; customers may not have cancellation rights, customers may not be covered by the FOS¹⁹ should they have a complaint about the fund or the FSCS²⁰ should they need to seek compensation);

- failing to highlight to the customer that the initial investment and target returns are not guaranteed;
- failing to consider and explain to the customer their access to the investment during a tie-in period and difficulties in exiting the schemes; and
- failing to provide a balanced view on benefits and risks.

The firms recommended customers to invest, or transfer, a high proportion of their investment or pension portfolio into UCIS, which resulted in the portfolio's risk tolerance being misbalanced and not matching the customer's overall attitude to risk, as well as not matching the customer's needs and objectives.

Our expectations

- 4.11 We expect firms to take reasonable steps to ensure that a personal recommendation is suitable for their customers. When making the personal recommendation, firms must obtain the necessary information regarding the customer's (a) knowledge and experience in the investment field relevant to the specific type of investments or service; (b) financial situation; and (c) investment objectives; so as to enable the firms to make the recommendation, or take the decision, which is suitable for the customer.
- 4.12 Whether firms are providing full or focused advice, we expect firms to consider the suitability of an individual transaction as well as its impact on the suitability of the client's overall portfolio. In some cases a transaction might be unsuitable if it would result in an unsuitable portfolio.

Our findings

- 4.13 We rated all the 24 cases that failed to demonstrate suitability of advice (see paragraph 4.6 above) as also inadequate on this point. Reasons for this included the following:
- the firms failed to consider the customers' other assets/overall portfolio; this resulted in the overall portfolios being unsuitable for the customers' attitude to risk, as well as for their needs and objectives;

19 Financial Ombudsman Service

20 Financial Services Compensation Scheme

- the firms recommended to invest up to 100% of the customers' investment and/or pension portfolio into one UCIS; and
- the firms recommended to borrow or re-mortgage in order to invest in UCIS, which put the customers' money and other assets at unnecessary risk.

The firms recommended investments which did not match the customer's attitude to risk, needs and objectives, and their overall personal and financial circumstances

Our expectations

- 4.14 Personal recommendations must be suitable to the customer's attitude to risk (ATR), needs and objectives, and their overall personal and financial circumstances. Hence, the firm is responsible for recommending a suitable product/wrapper as well as asset allocation suitable for individual customers in the light of their particular circumstances. The firms remain responsible for correctly assessing the advantages and disadvantage of both the wrapper and the underlying assets, which should also include costs and charges.

Our findings

- 4.15 Firms used SIPP as the most popular/widely used wrapper for UCIS investments. They used SIPP as conduit for UCIS.
- 4.16 In 58 (or 44%) out of the 131 UCIS files reviewed (see paragraph 4.4 above), the firms recommended customers to invest or transfer their existing pension arrangements into SIPP as these were the only vehicle for investing in some UCIS.
- 4.17 We rated 12 (or 50%) out of the 24 cases that failed to demonstrate suitability of advice (see paragraph 4.6 above) as also inadequate on this point. Reasons for this included the following:
- the firms used SIPP wrappers for UCIS, and neither the SIPP nor the UCIS were suitable for the customer's ATR and their needs and objectives; and
 - the firms failed to consider and to explain to their customers the implication of high costs and charges of some UCIS in addition to the SIPP overall charges (e.g. initial charge of 8%, annual management charge of 2%; an initial administration charge of £500; transfer penalty of 5.9% and fees of 5.6%).

Systems and controls

- 4.18 We reviewed the 14 firms' systems and controls by assessing the material provided to us by the firms and through interviewing relevant staff. Our findings below are under the headings of five key areas relating to unsuitable promotion and unsuitable advice which we considered during our assessments:
- due diligence on recommended UCIS;
 - sales process and strategy;
 - training and competence;
 - complaints; and
 - oversight (including monitoring and management information (MI))

Due diligence on recommended UCIS

Our expectations

- 4.19 Understanding individual UCIS and what they invest in is essential to ensuring the firm's compliance with its regulatory obligations. We expect firms to undertake due diligence on the UCIS they intend to use to help ensure the selection is suitable for their customers. We also expect that this is sufficiently documented.
- 4.20 We also expect firms to revisit this due diligence process periodically.
- 4.21 In 2007 the FSA issued Regulatory Guide 'The Responsibilities of Providers and Distributors for the Fair Treatment of Customers' ('RPPD') where we explain our expectations of those firms that distribute or pass on a promotion created by a provider (section 'Distributors responsibilities').
- 4.22 We expect firms to have in place systems and controls to manage effectively the risks posed by financial promotions; and to act with due skill, care and diligence.
- 4.23 A non-MiFID firm will not contravene the financial promotions rules where it communicates a promotion produced by another person provided the firm takes reasonable care to establish that another firm has confirmed compliance with the relevant detailed rules, amongst other matters (Note 16 of RPPD and COBS 4.10.10R).
- 4.24 As COBS 4.10.10R does not apply to MiFID firms and therefore MiFID firms cannot rely on a 3rd party and **must** take responsibility for the promotion.

4.25 We expect firms:

- to consider, when passing provider materials to customers, whether it understands the information provided (Note 17 of RPPD and COBS 4.2.1R);
- to ask the provider to supply additional information or training where that seems necessary to understand the product or service adequately;
- not to distribute the product or service if it does not understand it sufficiently, especially if it intends to provide advice; and
- when providing information to another distributor in a distribution chain, should consider how the further distributor will use the information, such as whether it will be given to customers. Firms should consider what information the further distributor requires and the likely level of knowledge and understanding of the further distributor and what medium may suit it best for the transmission of information.

Our findings

4.26 We rated 11 out of the 14 firms as having inadequate due diligence on this point. Reasons for this included the following:

- 11 firms passed the third parties UCIS information memorandum and/or other marketing material to customers, with a view for them to invest in the UCIS, without having an adequate understanding of the scheme's features, risks, conditions, etc.;
- Five out of the 11 firms were unaware of whether the schemes they promoted and recommended to their customers were regulated or unregulated CIS. In 82 cases the firms failed to highlight to their customers that the recommended schemes were unregulated; and
- in 43 cases written by eight firms, there was no or very limited evidence that the firms carried out any due diligence on the UCIS they had promoted and recommended to their customers;
- where the firms did carry out due diligence on the schemes they promoted, they still failed to understand the nature, structure or the risks of these schemes (e.g. liquidity risk, gearing, exiting the scheme, foreign currency risk, cancellation rights, potential loss of rights to the FOS/FSCS, and difficulty in asset valuation). As a result these firms failed to highlight and explain these risks to their customers.

Provision of advice/sales process and strategy

- 4.27 In addition to our expectations regarding firms' financial promotion processes (as set out in section 3 above), this section covers the processes of giving advice on UCIS to customers that have been established by firms as eligible for the promotion of UCIS.

Our expectations

- 4.28 We expect firms to have robust sales processes that allow them to recommend UCIS **only** to those customers that the firms have established as eligible for the promotion of UCIS. These processes include fact-finding (including the assessment of the customer's ATR), research and recommendation (including the approach to asset allocation and product selection).
- 4.29 Firms must also consider the overall costs of the solution they are recommending, including product, platform, UCIS and adviser charges (initial and ongoing) to ensure their recommendations are suitable in the light of alternative product options. (see paragraph 4.14).
- 4.30 We also expect that this is sufficiently documented in order to demonstrate that the firm has adequate procedures in place.

Our findings

- 4.31 We rated 11 out of the 14 firms as having inadequate sales processes as they failed to comply with the statutory restrictions on the promotion of UCIS to consumers and may have promoted and subsequently recommended UCIS to consumers where this is prohibited.
- 4.32 We rated 92 (or 70%) out of the 131 UCIS transactions (see paragraph 1.8 above) as having inadequate fact-finding. Reasons for this included the following:
- failing to establish the customers' needs and objectives;
 - failing to establish the customers' assets and liabilities in order to establish the impact of the firms' proposed solution on the customers' overall investment and/or pension portfolio;
 - failing to adequately or at all assess the customers' attitude to risk;
 - failing to establish the customer's knowledge and experience of financial products; and
 - failing to establish the source of the funds for the UCIS investment.
- 4.33 We established that only a few firms set up a maximum portfolio proportion for UCIS investments within their customers' portfolio and monitored it on on-going basis. This level was between 3% and 5% and was backed-up by the firms' robust and on-going due diligence and monitoring.

- 4.34 The majority of firms either failed to set up this maximum portfolio proportion for UCIS, or failed to monitor it and in some firms any proportion limits were not known to the advisers within the firms. This resulted in their advisers recommending up to 100% of the customers' overall portfolios to be invested in UCIS. We identified that these firms also did not have adequate due diligence and understanding of the risks relevant to the UCIS they were promoting and recommending.
- 4.35 We identified that a few firms had a strategy to recommend UCIS to all of their customers. Where the customers did not have available funds, these firms' strategy was to advise the customer to liquidate assets, borrow or re-mortgage in order to invest in UCIS.

Training and competence (T&C)

Our expectations

- 4.36 We expect firms to ensure their advisers are competent to provide the advice and services they offer, and to demonstrate good standards of ethical behaviour. This includes ensuring competence in any new areas of financial promotion and advice, for example, having the technical knowledge, skills and expertise to provide portfolio advice services or recommend 'non-traditional' investments such as UCIS.

Our findings

- 4.37 We rated three out of 14 firms as having adequate T&C and 11 out of 14 firms as having inadequate T&C. Reasons for inadequate T&C included:
- failing to understand and comply with regulatory requirements for the promotion of UCIS; and
 - failing to include any aspects of UCIS into their T&C arrangements (i.e. there are no knowledge testing on UCIS features, risks, regulatory requirements); this is especially pertinent to the five firms where advisers specialise in writing UCIS business and have their own UCIS customer bank.

Complaints

Our expectations

- 4.38 An authorised person that is carrying on regulated activities from an establishment maintained by it or its appointed representative in the United Kingdom, has an obligations under DISP²¹ to deal promptly and fairly with complaints received from retail customers/eligible complainants in respect of business carried on from that establishment.
- 4.39 We expect firms that promoted, advised on or otherwise arranged UCIS, to investigate promptly and fairly any complaints received from their customers in respect of the firms' UCIS business.

Our findings

- 4.40 Although 12 out of 14 firms did not receive any complaints regarding the UCIS they promoted and recommended, they were aware that should they receive any in future they would investigate them.
- 4.41 Two firms failed to understand the regulatory requirements for UCIS and therefore, to investigate complaints regarding UCIS.

Oversight (including monitoring and management information ('MI'))

Our expectations

- 4.42 Firms must establish and maintain appropriate monitoring and oversight arrangements to ensure they act in their customers' best interest, promote UCIS for which the customers are suitable, and provide suitable advice on these UCIS. Appropriate monitoring would/should include customer outcomes, due diligence on UCIS, the specific risks of UCIS, and the suitability of advice.
- 4.43 A firm should have appropriate arrangements to ensure that sufficient management information ('MI') is generated to enable its management to identify regulated and unregulated (including UCIS) investments, to review and monitor UCIS promotion and advice to enable it to act on risks and to ensure suitability of advice is delivered to suitable for UCIS promotion customers. This would also include identifying good and poor outcomes for customers and developing key performance indicators to measure performance against these.

21 The FSA 'Dispute Resolution: Complaints' handbook

- 4.44 Where firms are introducing a new investment proposition (e.g. UCIS) then they should consider their oversight arrangements, risk management procedures and MI to ensure the arrangements remain fit for purpose. When a firm changes its practices, it is very likely that new risks may arise which need to be managed and monitored.

Our findings

- 4.45 We found that 4 (or 29%) out of the 14 firms did not monitor their UCIS business.
- 4.46 We found that 10 (or 71%) out of the 14 firms were monitoring their UCIS business. We rated 8 out of the 10 firms as having inadequate monitoring. Reasons for this included the following:
- failing to comply with the statutory restrictions on the promotion of UCIS to the general public and the exemptions to the restrictions;
 - failing to include UCIS in their T&C arrangements;
 - failing to ensure and demonstrate suitable advice was provided to their customers; and
 - we found that 21 (or 16%) out of the 131 UCIS cases reviewed were monitored by the firms. In 8 (or 38%) out of the 21 cases this monitoring was inadequate as they failed to identify issues raised in sections above.
- 4.47 We rated the remaining two firms as having adequate monitoring and oversight of their UCIS business. They also had adequate selling practices and T&C arrangements for UCIS business (see 4.37 above).
- 4.48 Some firms had total over-reliance on their compliance consultants for guidance on any regulatory requirements for UCIS business. Prior to the FSA project visit, these firms made no attempts to find out about the FSA requirements for UCIS.

Project methodology

1. The objective of the project was to look at firms' financial promotions and advice processes for the sale of UCIS and to assess whether firms are complying with FSA rules and regulations in providing fair outcomes for consumers. In broad terms there were three stages:

Questionnaire

2. We requested 185 firms to complete our on-line questionnaire, of which 67 firms were selected as they had sold UCIS during the period 2007 and 2009 ('selling firms') and 118 firms were selected randomly ('random firms'). We asked the firms about the level of UCIS business they had transacted during the relevant period; type of UCIS they have promoted and recommended to their customers; the firms' communication of UCIS to their customers; the firms' UCIS customer types; the firms' level of service provided (i.e. advised or non-advised); complaints; and UCIS portfolio reviews and monitoring.
3. The firms' responses to the questionnaire made some adjustments to our initial data of UCIS selling firms, as they identified 66 firms that have sold UCIS during the period 2007 and 2009, of which 57 firms came from our sample of selling firms and 9 firms came from our random sample.
4. The questionnaire analysis involved a high level assessment of the firms' UCIS business and practices surrounding it on the basis of information we had asked the firms to submit.
5. The purpose of the analysis was to make a preliminary assessment of the possible risk the firm posed. It did not involve a full assessment of the firm.
6. This was the primary source of the 66 firms for the questionnaire analysis.

Further work – customer files review

7. Our main selection criterion for our further work was that the firms had written UCIS business during 2008 and 2009 ('relevant period').
8. We selected 14 (or 21%) firms for our further work. Our selection criterion was that 85% of these firms (or 12 firms) were top adviser firms by number of UCIS customers during the relevant period. The remaining 15% of the firms (or 2 firms) have written UCIS business to an average number of 15 customers. In total, the 14 selected firms advised on UCIS to 1,020 customers over the relevant period, with the total initial investment in UCIS of almost £57.9m.¹
9. Based on the firms' new business registers, we requested 10 UCIS customer files from each firm written during the relevant period for our preliminary assessment of the firms' UCIS financial promotion processes and quality of advice.

Further assessment – visits and desk-based reviews

10. We selected 7 firms for our desk-based review and 7 firms for visits, based on the level and quality of information held in the sample out of the 10 UCIS customer files requested.
11. The review vehicles involved two elements:
 - selling practices review: we continued with an in-depth review of the 10 customer files selected for both suitability of customers for UCIS promotion and for quality of advice (suitability); and
 - systems and controls: expanding on the information the firms had sent us, we interviewed relevant staff with each firm to assess the systems and controls the firm had in place for ensuring UCIS were promoted to suitable customers and suitable advice was provided.
12. In total, we reviewed 131 UCIS transactions for 120 customers that have been promoted and/or recommended 73 different UCIS during the relevant period. In the majority of files the firms promoted UCIS (119 cases) and provided advice-based sale (109 cases). There were 12 cases where there was no promotion of UCIS (discretionary portfolio sale), and 22 cases where the advice was not provided (e.g. execution only and discretionary portfolio sale).
13. We provided individual responses to all 14 firms, of which 11 firms had specific action points to address and to report back to us:

¹ The initial figures provided by these firms to our UCIS questionnaire were 2,900 clients with £197m of their initial investments in UCIS. These figures were revised by the firms during our further work.

Voluntary variation of permissions

- We invited 11 firms to vary their permissions such that they cease advising on, arranging or otherwise promoting, any UCIS transactions, including transfers from one UCIS to another, or any other scheme or product which involves investment in such unregulated schemes, to any of its customers, until a full review has been completed by skilled persons and any required actions undertaken.

Skilled persons review

- We required these 11 firms to appoint a skilled person under section 166 FSMA to conduct a review of all of the firms' sales of UCIS in order to assess all of the firms' UCIS customers and whether historical instances of the firms' promotion of UCIS were, in each instance, compliant with the restriction imposed by section 238 FSMA, having regard to any applicable exemption under the PCIS Order and/or under COBS 4.12. In those cases where the promotion was not compliant and the customer was not eligible for the promotion of UCIS, the Skilled Person will also propose appropriate redress. This may also result in firms being required to pay redress to customers.
- We required four of these 11 firms also to carry out a skilled person's report under section 166 FSMA to review the advice given by the firms on UCIS in order to assess the suitability of the recommendations and, where applicable, propose appropriate redress where cases of unsuitable advice are identified. This was required for those UCIS promotions that complied with section 238 of FSMA. This may also result in firms being required to pay redress to customers.

Past-business review by firms

- We required five firms² to carry out past business reviews of their UCIS advice to assess its suitability and, where applicable, propose appropriate redress where cases of unsuitable advice are identified. This may also result in firms being required to pay redress to customers.

Discussions with enforcement

- We are discussing a number of firms with the Enforcement and Financial Crime Division with a view to potential referral in relation to issues raised by this work, primarily due to concerns of non-compliant promotions and that customers that may not be eligible for the promotion of UCIS have been promoted UCIS, as well as the firms' failure to demonstrate suitability of advice provided to customers as a result of training and competence failings and inadequate systems and controls at the firms.

² We did not require five firms to review files for the suitability of advice; this includes one firm that only provides non-advice services on UCIS.

Systems and Controls (including financial promotions, T&C, Complaints, monitoring)

- We required 11 firms to review and align their Financial Promotion processes and practices in respect of UCIS to the requirements under section 238 FSMA, the PCIS Order and COBS 4 ‘Communicating with customers, including financial promotions’.
- These firms were also required to demonstrate their understanding of the restriction and exemptions; and to evidence it in their formal written procedures and processes for the promotion of UCIS to their consumers, and to provide FSA with copies of its UCIS promotion procedures and T&C arrangements.
- Two firms were required to fully investigate complaints they received from their customers to whom the firms promoted and recommended UCIS.
- Some firms indicated to us that although they will undertake all remedial actions required by the FSA, they would not promote and advise on UCIS in future.

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