Four Compliance Tips

FOUR COMPLIANCE TIPS FROM AUGUST 2013

Firms need to put away their standard risk warnings and integrate a description of the risks involved in their products into their general descriptions of those products.

- The use of "your investment can go down as well as up" (or is it the other way around?!) needs to be despatched to the history books. The risk is that the investment will go down in value - not that it will go up. The words "as well as up" are just uninformative and confusing.
- It is far better to talk about an investment management service as one "designed to help the clients deal with the ups and downs of markets". This reads naturally and actually describes both the risks and the service involved. Customers need help in managing the "ups" to obtain the full benefit of rises in investments.
- In any event, firms must not routinely bring out their standard collection of what one business calls its "caveats" for all their promotions. This shows a failure to understand the regulatory requirements in this area. These are that firms must describe the risks involved in the product or service concerned and be "clear, fair and not misleading". On top of that, internal communications in bad Latin says something about the clarity of thought being used!

The use of contract terms and other legalese will not prevent an investment arrangement from becoming a "collective investment scheme".

- In a number of court decisions this year, notably the Asset Land and European Property cases, the Courts have rejected the argument that contract terms, denying that the business was offering certain services, can be used to stop a transaction falling within the definition of "collective investment scheme" (CIS) contained in section 235 of the Financial Services and Markets Act.
- FSMA creates two criminal offenses in this area for persons who have not been authorised by the Financial Conduct Authority: operating a CIS without authorisation (or being exempt from that requirement generally) and promoting such a scheme except through non-interactive communications that have been approved by an authorised firm. The Financial Conduct Authority has announced that it is bringing prosecutions for these two offenses in this area.

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- It is not an argument for recommending or transacting business with unregulated collective investment schemes that an adviser could not know the full details of a regulated one.
- Regulated schemes provided by reputable firms with good track records investing in mainstream assets do provide a greater degree of security than their unregulated counterparts. While the managers of authorised funds breach their mandates, mislead their customers and run out of liquidity, this happens far more frequently with unregulated than authorised schemes.
- The current long-term suspensions of a number of unregulated funds should put advisers off recommending anything (being it regulated or not) that does not consist of traditional asset types (such as equities, bonds, cash and property).
- An adviser usually needs intimate knowledge of the type that can only be gained from running an unregulated collective scheme or other non-mainstream investment in order to have sufficient knowledge to be able to recommend it sensibly.

Product providers should no longer hope to rely in the future on their distributors being exclusively liable for problems with badly designed products. Advisers must not recommend products and in particular funds whose contents they cannot identify or do not understand.

- The enormous body of literature produced by the FSA in its last days on product manufacturing imposed responsibilities on insurers, fund providers and other manufacturers in the areas of stress-testing, meeting the needs of target markets, distribution selection and the provision of clear, fair and not misleading marketing material.
- Schedule 2 of the Consumer Insurance (Disclosure and Representations) Act 2012 (which strictly speaking does not apply to this problem) may encourage this development further. It assumes that the distributor is acting for the insurer where the "agent" only sells one company's policy for that type or category of insurance (such as payment protection, critical illness, health or household contents) or is legal restricted to selling only a number of insurers' products or the provider only uses a small number of agents. This changes the view taken by the Financial Services

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Authority. The regulator then said that a firm selling more than one provider's products was the agent of the consumer and not that of the insurer or provider at least in the investment area.

- If providers are to be responsible for the selection and monitoring of distribution, a failure to do this in the face of obvious misselling by a distributor could legitimately make the Financial Ombudsman Service ("FOS") hold the provider liable for future misdeeds. This would bring the FOS into line with the 1989 Insurance Ombudsman Bureau Annual Report suggestion in this area. FOS already makes providers responsible for bad sales practices of distributors where distributors were only selling their products of the relevant type if the distributor is not itself subject to the Ombudsman's jurisdiction in the case concerned.

Out and about news

On 25th September, I'm running an executive seminar for the Hong Kong Securities Institute entitled Treating Your Customers Fairly and Regulating Your Products. The event website is at http://www.hksi.org/hksi/index.php?option=com_training&view=details&id=1234&Itemid=149&lang=en . Back home on October 31st, I will be doing an Infoline workshop on product development. For this, see http://www.infoline.org.uk/event/Product-Governance-Under-the-FCA

Have a compliant autumn

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