Financial Services Authority

Unregulated Collective Investment Schemes:

Good and poor practice report

July 2010

Contents

1 Introduction

1.1 This guide sets out good and poor practice when promoting and providing investment advice on unregulated collective investment schemes (UCIS). It aims to help intermediary firms to understand ways of meeting our Rules and Principles as well as risks and practices to avoid. For the purposes of this guide, good practice means either effective compliance with our Rules and Principles, or exceeding them.

1.2 This guide refers to examples seen during our project that reviewed the promotion and investment advice on UCIS. It should be read in conjunction with the UCIS Project Findings Report.[1] More information can be found in the UCIS Factsheet.[2]

1.3 This guide is divided into four sections:

- regulatory requirements for UCIS;
- financial promotions of UCIS to retail customers;[3]
- quality of advice; and
- systems and controls.

The good and poor practices are prefaced by a summary of key risks firms need to guard against. These examples and the risks are not exhaustive and relate specifically to firms' processes and practices in relation to promoting and advising on UCIS. However, they do not cover specific risks that may apply to a particular UCIS or individual firms. The good practice examples are simply that – examples; firms can meet our Rules and Principles in different ways. For further information please refer to our UCIS Factsheet.

1 UCIS Project Findings Report on www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/findings.pdf
2 UCIS Factsheet on www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/ucis_factsheet.pdf
3 Meaning of 'customer' here includes 'potential customer'.

2 Good and poor practice: regulatory requirements for UCIS

2.1 Key risks include but are not limited to:

- UCIS are promoted, and subsequently sold on an advised or non-advised basis, to customers that are not eligible for the promotion of this type of investments;
- UCIS are promoted and recommended by advisers that are not competent to transact and discuss this type of investment with customers;
- customers' complaints relating to the promotion and selling of UCIS are not investigated; and
- UCIS business is not supervised and monitored by firms.

Examples of good practice

1. Firm is aware of the statutory restrictions[4] on promoting UCIS to the general public and exemptions[5] to these restrictions; and aligns its processes and practices adequately.

Examples of poor practice

2. Firm believes as we do not regulate UCIS, none of our Rules apply to the firm's UCIS business.
3. Firm is not aware of the statutory restrictions on promoting UCIS to the general public and exemptions to these restrictions.
4. Firm does not train its selling staff on all aspects of UCIS they promote and recommend to their customers, as it believes it is not required to do so as we do not regulate the scheme.

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4 The Financial Services and Markets Act 2000 (FSMA), section 238.

5 Exemptions in:
(1) The Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes (Exemptions) Order 2001 (SI 2001/1060) (as amended) – we refer to it here as 'the PCIS Order'; and
(2) Chapter 4.12 of The FSA Conduct Of Business Sourcebook – we refer to it here as 'COBS 4.12'.

5. Firm does not investigate complaints relating to UCIS as it believes it does not have to as we do not regulate the scheme.
6. Firm does not supervise its selling staff or monitor their UCIS business as it believes it does not have to as we do not regulate the scheme.

3 Good and poor practice: financial promotion of UCIS

Definition of 'financial promotions'

3.1 Key risks include but are not limited to:

- Firms' lack of understanding of 'financial promotion' leads to confusion regarding the type of services they provide when introducing UCIS to customers (i.e. promotion and advice).
- Unknowingly, firms promote UCIS to their customers (i.e. introduce customers to UCIS and/or induce them to invest in UCIS) where this is prohibited as the customers are not eligible for this type of investment; putting customers at significant risk of receiving unsuitable advice.
- Firms act in breach of the scheme promotion restriction and risk tough disciplinary action and actions for damages (under the Financial Services and Markets Act 2000 (FSMA) section 150).

Examples of good practice

1. Firm has a good understanding of what constitutes 'promoting' and is aware that it does not solely mean communicating through a written financial promotion, (e.g. marketing literature, email or letter) but also includes verbal communication, (e.g. face-to-face discussion, providing advice, phone calls, presentations, seminars etc.)

Examples of poor practice

2. Firm doesn't understand the meaning of 'financial promotion'. The firm believes it does not promote UCIS to its customers as it does not issue paper-based material (e.g. adverts in newspapers, brochures, flyers, direct offer letters), but only advises on UCIS and provides its customers with UCIS information memorandum and/or other literature which is designed by the UCIS promoter or fund manager.

3. Firm introduces a particular UCIS to its customers when presenting on investments in that UCIS (as part of the firms' sales process). The firm does not consider verbal communication (e.g. face-to-face discussion, phone calls etc.) as financial promotion.
4. Before giving advice on a particular UCIS, the firm provides its customers with UCIS information memorandum and/or other literature which is designed by the UCIS fund manager. The firm does not consider this a 'financial promotion'.
5. Firm advertises a particular UCIS in the press and via its website, which are accessible to retail clients and the general public.
6. Firm promotes a particular UCIS via its own direct-mail before assessing the customers' eligibility for the promotion of UCIS.
7. Firm invites customers to its roadshows/seminars, where the firm refers to a particular UCIS, before assessing whether the customer is eligible for the promotion of UCIS.

Restrictions on and exemptions to the promotion of UCIS

3.2 Key risks include but are not limited to:

- firms promote UCIS to their customers where this is prohibited as customers are ineligible for promotions of this type of investments; and
- firms act in breach of UCIS promotion restrictions and risk tough disciplinary action and actions for damages (under FSMA section 150).

Examples of good practice

1. The firm used the exemptions under the Conduct Of Business Sourcebook (COBS 4.12) for category 2 persons for whom the firm has taken reasonable steps to ensure that investing in the collective investment scheme is suitable. The firm adequately assessed its customer's personal and financial circumstances as well as his knowledge and understanding to ensure the customer is eligible for promoting UCIS. The firm kept a record of exemption/s which they were relying on when promoting a UCIS, and the reasons why they apply. The firm provided its customers with written explanations as to why their personal recommendation was suitable.
2. The firm used the exemptions under article 21 of the PCIS order for high net worth individuals. The firm retained a copy of statement of a high net worth individual, in a prescribed text and format and dated before promoting UCIS began.

Examples of poor practice

3. The firm was unaware of the restrictions on promoting UCIS to the general public, nor the exemptions to these restrictions.
4. The firm was aware of the restrictions, but believed they do not apply to the firm as it was only advising on UCIS and not promoting them to their customers.
5. The firm was aware of the restrictions and exemptions, but it is confused as to how to apply them to its UCIS business. It was not aware it has to assess its customers' eligibility for a particular UCIS, before it begins its advising process.
6. Firm was aware of the restrictions and exemptions, but did not keep any records of the exemption/s on which they were relying when promoting a UCIS, and the reasons why the exemption/s apply.
7. The firm was not aware of the definition of 'professional', 'sophisticated' and 'high net worth' investors as set out in the PCIS Order and in COBS 4.
8. The firm understands the definition of a 'sophisticated' investor. The firm explained to its customer that it did not believe the customer falls into this category. However, despite this, the firm promoted and advised on UCIS to this customer.
9. The firm was not aware of the exemption for high net worth companies set out in article 22 of the PCIS Order.
10. The firm was obtaining certificates for high net worth individuals signed by the customer's accountant. The firm was not aware 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.
11. The firm was unaware of the newly introduced exemptions for self-certified sophisticated investors as set out in article 23A of the PCIS Order.
12. When applying the PCIS Order exemptions, the firm induced customers to sign and backdate 'Certificates of high net worth investors' to complete the UCIS transaction.
13. When applying articles 21-23A of the PCIS Order exemptions, the firm incorrectly included a statutory warning into the customer's statement of high net worth individual. Firm was not aware of the requirements for the warning.

4 Good and poor practice: quality of advice (suitability)

Know your customer (KYC) information

4.1 Key risks include but are not limited to:

- firms promoting UCIS to their customers when customers are not eligible for promotions of this type of investments; and
- firms recommending UCIS to their customers based on out-of-date or limited KYC. There is a risk that UCIS may not be suitable for the customer's personal and financial circumstances.

Examples of good practice

1. The firm obtains and retains full KYC, including the customer's assets, other investments and their underlying assets; their objectives and needs for immediate income, their knowledge and experience in the investment field relevant to the specific type of investments or service; and attitude to risk (ATR). The firm uses this to establish the customer's eligibility for the promotion of UCIS.

Examples of poor practice

2. The firm did not gather KYC before recommending UCIS to the customer.
3. The firm gathered limited KYC information, i.e. there were no details of the customer's current portfolio or their underlying assets. The firm recommended UCIS which actually made up almost 70% of his investment portfolio.
4. The firm did not assess their customers' knowledge and experience in the investment field relevant to the specific type of investments, yet still recommended UCIS to its customer, believing the customer was sophisticated investor.

5. The firm assessed the customer's assets and included their main residence and pension funds. On this basis, the firm considered the customer to be a high net worth individual.
6. Firm relied on the customer to complete the KYC and assess his own ATR. The firm did not review or validate this completion.

Quality of advice (suitability)

4.2 Key risks include but are not limited to:

- Firms are unable to demonstrate the suitability of their advice, and place their customers at risk of receiving unsuitable advice.

Examples of good practice

1. The firm provided full advice based on a comprehensive assessment of the customer's personal and financial situation. The firm considered the suitability of the recommended UCIS transaction as part of the customer's overall portfolio risk tolerance, his ATR and the need for capital/income.
2. The firm issued a written confirmation and highlighted all the risks, costs and charges pertinent to their recommended product and its underlying UCIS and clearly explained why UCIS is suitable for the customer. The firm also explained that UCIS are not regulated, that the customer did not have cancellation rights, and may not be covered by the FOS[7] should they have a complaint about the fund or the FSCS[8] should they need to seek compensation.

Examples of poor practice

3. The firm did not tell the customer that the recommended scheme is unregulated. The firm did not highlight all relevant risks of an unregulated scheme (e.g. UCIS frequently invest in assets that are less/not liquid, some UCIS are geared, customers may not have cancellation rights, customers may not be covered by the FOS should they have a complaint about the fund or the FSCS should they need to seek compensation).
4. The firm told the customer that returns are guaranteed rather than targeted. The firm did not give a balanced view on benefits and risks of investing in UCIS.
5. The firm did not explain to the customer that they will not have access to their investment during a tie-in period or even after it, as exiting the scheme was only on the discretion of the fund manager.

7 Financial Ombudsman Service
8 Financial Services Compensation Scheme

6. The firm did not consider the customers' overall portfolio; this resulted in 100% of their portfolios being invested in UCIS, which was unsuitable for the customers' attitude to risk, as well as for their needs and objectives.
7. The firm assessed the customer's assets available for new investment; due to a lack of them the firm recommended the customer borrow or re-mortgage to invest in UCIS, which put the customers' money and other assets in unnecessary risk.
8. Firm used SIPP[9] as wrapper for UCIS, with neither the SIPP nor the UCIS being suitable for the customer's ATR and their needs and objectives. The firm did not consider or explain to their customers the implication of costs and charges of the recommended 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%).

9 Self-Invested Personal Pension

5 Good and poor practice: systems and controls

Due diligence on UCIS

5.1 Key risks include but are not limited to:

- Inadequate initial and/or on-going due diligence on UCIS (e.g. its features and risks) and on its operator/manager leads to provision of unsuitable advice and putting the customer at risk of losing not only his initial investments but other assets (where the scheme is geared).
- Inadequate due diligence also puts firms' capital resources and reputation at risk should thing go wrong in the recommended scheme.

Examples of good practice

1. The firm carried ongoing due diligence on the recommended UCIS, its underlying investments and its fund manager. As a result, the firm made a timely decision to take its customers out of some UCIS before the scheme experienced liquidity difficulties. The firm kept sufficient records of their due diligence.
2. The firm asked UCIS fund manager for, and obtained additional information and clarification on their UCIS, as well as training to its senior advisers to help them to understand the product adequately.

Examples of poor practice

3. The firm conducted no due diligence on UCIS they recommended. The firm relied on the UCIS information memorandum provided by the fund manager. The firm did not adequately understand the scheme's features, risks, conditions, etc. However, the firm still passed this on to their customers for them to read and understand and to make their decision to invest.

4. The firm conducted limited due diligence on a scheme they recommend. It also did not know whether the scheme was regulated, unregulated or in fact UCIS; did not know the name of the fund manager; where the fund was based or its underlying investments.
5. The firm received initial presentation /training from the scheme fund manager however, it did not do any on-going reviews.

Sales processes and procedures

5.2 Key risks include but are not limited to:

- Firms with no or weak formal sales processes risk UCIS being recommended or arranged when they are not suitable for the customer.

Examples of good practice

1. The firm 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.

Examples of poor practice

2. The firm had a strategy to put all of its customers and all of their money into one UCIS.
3. The firm had a strategy to recommend UCIS to all of its customers. Where customers did not have available funds, its strategy was to advise the customer to liquidate assets, borrow or re-mortgage in order to invest in UCIS.
4. The firm did not have a maximum portfolio proportion for UCIS that they considered suitable for their customers.
5. The firm had an informal maximum portfolio proportion for UCIS that it considered suitable for its customers. However, this level was not known to their advisers and was not monitored by the firm. This resulted in its advisers recommending up to 100% of customers' overall portfolios to be invested in UCIS. We identified that the firm also did not have adequate due diligence and understanding of the risks relevant to the UCIS it was promoting and recommending.

Training and competence ('T&C')

5.3 Key risks include but are not limited to:

- UCIS are promoted and recommended by advisers that are not competent to transact and discuss this type of investment with customers.

Examples of good practice

1. The firm researched and approved one UCIS, which its advisers were allowed to discuss with its customers. The firm had a limited number of advisers that were allowed and competent to promote and advise on UCIS. UCIS were included in their CPD and annual knowledge testing. The advisers had investment management qualifications, the technical knowledge, skills and expertise to provide portfolio advice services and recommend 'non-traditional' investments.

Examples of poor practice

2. The firm did not include UCIS in their training programme, therefore the firm did not provide any training to their advisers nor did it test their understanding. Its directors did not know whether its advisers were competent to transact this type of business.
3. The firm received a half-day presentation from a UCIS fund manager, however, the firm did not test the advisers' knowledge and understanding of this UCIS after the presentation; the firm did not provide any revision or subsequent training sessions for the advisers that were active in UCIS business. The advisers we interviewed could not explain any risks pertinent to the UCIS they have been recommending for the last two years. The advisers risked misinforming their customers about the risk. We found unsuitable advice provided by the Firm in a significant number of cases.

Complaints

5.4 Key risks include but are not limited to:

- Customers are not being treated fairly by the firms that promoted, advised or otherwise arranged UCIS to them. The firms did not investigate complaints received from these customers in respect of the firms' UCIS business.

Examples of good practice

1. The firm treated a UCIS complaint like any other complaint.

Examples of poor practice

2. The firm advised the customer that they did not investigate UCIS complaints as they believed they did not have to investigate them as the scheme was unregulated.

Oversight

5.5 Key risks include but are not limited to:

- UCIS are promoted and recommended by firms where there is no appropriate monitoring or oversight arrangements to ensure they act in their customers' best interest, promote UCIS for which the customers are eligible, and provide suitable advice on these UCIS.

Examples of good practice

1. After completing UCIS questionnaire, the firm reviewed its UCIS financial promotion and selling processes, identified gaps, and stopped promoting and advising on UCIS until our project review was completed. The firm implemented remedial actions, part of which was a contact with their customers. During our project work, we found the firm's promotion of UCIS was compliant with COBS 4, suitable advice was provided to the consumers that were eligible for the promotion of UCIS in all files reviewed; robust due diligence and T&C[10] including the advisers' knowledge testing were part of the firm's culture.
2. The firm has a file review checklist for UCIS.

Examples of poor practice

3. The firm did not monitor their UCIS business.
4. The firm did not monitor the proportion of UCIS in their customers' portfolios.
5. The firm told us they had formal monitoring in place. However we found this monitoring to be inadequate. The firm was not aware of the restrictions on the promotion of UCIS to the general public and the exemptions to the restrictions. The firm did not include UCIS in their T&C arrangements. The firm did not demonstrate suitable advice was provided to their customers.

10 Training and Competence

6. Firm placed their total reliance on compliance consultants for guidance on UCIS. Prior to the FSA visit, the firm have made no attempt to find out about our requirements for UCIS.
7. Firm did not collect any management information for UCIS – no records of UCIS on their new business register, no records of whether it was direct or indirect or switch sale; no records of available exemptions on the customers' files or the firm's NBR.

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