Financial Conduct Authority

Wealth management firms and private banks

Suitability of investment portfolios

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Thematic Review

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Contents

1.
Summary

Overview

1.1 The UK wealth management industry plays a vital role in delivering financial services to consumers. Firms in this industry provide a range of services, including financial planning, investment advice, investment management and stockbroking. The industry manages over 1.8 million portfolios for customers in the UK and has over £600 billion of their assets under management[1].

1.2 This report presents the findings from our review of suitability of retail investment portfolios provided by wealth management and private banking firms and includes examples of good and poor practice to help firms better understand the standards expected of them. It follows our earlier thematic reviews of suitability in a sample of wealth management firms, carried out in 2010, which led to the FSA's Dear CEO letter[2] in June 2011 and was followed by further work in 2012[3].

1.3 The key issues that we identified in many firms from this earlier work were:

- an inability to demonstrate suitability, for example because of absence of up-to-date customer information, inadequate risk profiling, or failure to record customers' financial position and/or their investment knowledge and experience and
- a risk of unsuitability[4] due to inconsistencies between portfolios and the customer's attitude to risk, investment objectives and/or investment horizon.

1.4 Regulatory action[5][6][7] was taken with some of the firms involved. A number had to undertake substantial back book reviews to ensure they could demonstrate that they were providing customers with suitable investment portfolios.

1.5 Our Dear CEO letter communicated our expectations on suitability standards in the wealth management industry and we stated that there would be continuing and increasing supervisory focus on the issues covered.

1 Compeer Limited, UK Wealth Management Industry report 2015 Wealth Management Industry: An expanding market in all conditions
2 FSA's Dear CEO letter June 2011 www.fca.org.uk/your-fca/documents/fsa-our-letter-to-wealth-management-firms
3 The FCA's approach to supervising wealth management and private banking firms www.fca.org.uk/news/wealth-management-private-banking-approach
4 A failure to comply with COBS 9
5 FSA Final Notice 2012: Savoy Investment Management Limited www.fca.org.uk/your-fca/documents/final-notices/2012/fsa-final-notice-2012-savoy-investment-management-limited
6 FCA Final Notice 2013: J.P. Morgan International Bank Limited| www.fca.org.uk/your-fca/documents/final-notices/2013/fca-final-notice-2013-jp-morgan-international-bank-limited
7 FCA Final Notice 2014: Santander UK Plc www.fca.org.uk/your-fca/documents/final-notices/2014/santander-uk-plc

1.6 The objective of the project that we have just completed was to determine whether firms managing investment portfolios for retail customers had acted on the concerns highlighted during our previous thematic reviews. We explored this through a mixture of desk-based analysis, including client file reviews, and visits to a smaller number of firms within our project sample. Where we have identified areas where further improvement is still needed, we are now seeking to highlight these by sharing appropriate messages with the market.

1.7 Overall, the results show some improvement in the market, when compared to our work on suitability in 2010. However, there was a wide variation in the performance of individual firms in our sample. While some appeared to have taken on board the messages contained in our 2011 Dear CEO letter and subsequent communications, it was clear that many still need to raise their standards – in some cases substantially - to be able to demonstrate that they are providing their customers with investment portfolios that are suitable for their needs and circumstances.

1.8 Firms that do not adequately document their customers' circumstances, investment aims and risk appetite and provide them with portfolios that match these, expose customers to the risk of loss and themselves to complaints and claims for redress if customers lose out as a result.

1.9 The main messages from our work are:

A number of firms have taken steps to both improve and demonstrate the suitability of customer investment portfolios

Many firms still have to make substantial improvements in gathering, recording and regularly updating customer information to support the investment portfolios they manage for customers

Firms need to do more to ensure that the composition of the portfolios they manage truly reflects the investment needs and risk appetite of their customers, especially those who have a limited capacity for, or desire to expose themselves to the risk of, capital loss

Firms need to ensure that their governance, monitoring and assessment arrangements are sufficient to meet their regulatory responsibilities in relation to suitability

1.10 We expect firms to take note of our findings and ensure that they are able to demonstrate how the portfolios they manage are suitable.

1.11 In order to do this, we expect senior management to consider whether any of the concerns we raise in this report are reflected within their own firms' practices and to take any action necessary to minimise the risk of unsuitable outcomes to customers.

1.12 We have written to all the firms in our project sample and given them individual feedback.

Who is this thematic review aimed at?

1.13 This document is relevant to all firms that provide discretionary and or advisory portfolio management services to customers. It will also be of interest to those that may provide third party support services, such as compliance services, to these types of firms.

What do you need to do next?

1.14 Firms providing discretionary and advisory portfolio management services to retail customers must ensure that they can demonstrate that their customer portfolios are suitable. They should study the findings of this report, in particular the examples of good and poor practice that we have identified from our file reviews and on-site visits to firms in our sample. They may want to benchmark their own performance against these and consider whether there are any changes that they need to make to ensure they meet their regulatory responsibilities and that their customers are receiving suitable outcomes.

1.15 Firms need to embed practices that ensure that they are consistently reviewing and continuing to meet their customers' needs where they have agreed to provide an ongoing service, to secure the longer-term success of the UK's world-leading wealth management and private banking industry. We are committed to working with the sector to help further improve standards.

1.16 As well as looking at the results of this work, it would be useful for firms to revisit an earlier publication, the 'FSA's Finalised guidance Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection, March 2011[8]'. This report is relevant to firms providing investment advice and/or discretionary management services to retail customers.

Markets in Financial Instruments Directive II

1.17 Firms providing portfolio management services to retail customers need to be aware of the changes to the Markets in Financial Instruments Directive (MiFID), which is the framework of European Union (EU) legislation for:

- investment intermediaries providing services to clients in relation to shares, bonds, units in collective investment schemes and derivatives (collectively 'financial instruments') and
- the organised trading of financial instruments

1.18 MiFID was applied in the UK from 1 November 2007. But it is now being comprehensively revised to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection. It will be known as MiFID II.

1.19 Firms will need to start planning for the changes ahead of the finalisation of the EU implementing legislation and the subsequent changes we make to our Handbook and the Treasury makes to financial services legislation. MiFID II is a wide-ranging piece of legislation and, depending on the business model, could affect a wide range of a firm's functions – from client services to IT and HR systems. You can find out more information on the changes on our website.[9]

8 FSA's Finalised guidance Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection, March 2011 www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg11-05

9 www.fca.org.uk/firms/markets/international-markets/mifid-ii

2. Methodology and findings

What we did

2.1 Our thematic review was focused on the wealth management and private banking sector to identify the extent to which it was in a position to demonstrate the suitability of discretionary and advisory investment portfolios managed for retail customers. This included reviewing the customer information collected and updated and assessing whether the portfolios were suitable.

2.2 We assessed 150 files from 15 firms. We initially asked each firm to provide us with a list of customers and some basic information for each customer, including the value of the account balance, as well as other information relating to the firm's approach to delivering its wealth management services.

2.3 From the customer lists we randomly selected 10 files for each firm, while ensuring that each file sample contained a mixture of accounts with different levels of balances within the firm's customer base. We then asked firms to provide copies of the files to us so we could carry out a suitability assessment. Our review followed the same approach to assessing suitability within retail customer investment portfolios as our previous work in 2010 and 2012, so that we could measure what progress had been made within the sector.

Our assessment approach

2.4 We considered a range of criteria in assessing the suitability of customers' investment portfolios. In particular, we assessed whether the firms' met the following standards in relation to the suitability of the investment, including customer's best interests and the clarity of charges:

- the investment portfolio was consistent with the customer's attitude to investment risk and objectives (COBS 9.2.2 (1))
- the investment service was provided as described and agreed with the customer (COBS 2.2.1)
- information on the customer's attitude to investment risk and objectives was recorded and kept up to date, which is relevant to the continuing suitability of the portfolio (COBS 9.2.2(1))
- levels of portfolio turnover were in line with the agreed investment strategy and did not indicate churn or neglect (COBS 9.3.2)
- in-house products or funds held in investment portfolios was in the best interests of customers (COBS 2.1.1) and

- the charges levied on the portfolio were in line with those quoted to the customer, and were set out clearly in the periodic reports to customers (COBS 16 Annex 2)

2.5 After analysing the results of the file reviews, we decided to visit a sample of firms. Our aim was to explore further their governance arrangements and control environments to manage risks to delivering suitable investment portfolios.

2.6 The firms that we visited included those where our file review results indicated improvements were needed and those which appeared to be delivering suitable outcomes.

2.7 We spoke to a range of people, including senior management, customer advisers[10] and compliance staff and considered:

- whether customer risks arising from firms' arrangements had been adequately identified and mitigated
- the adequacy of oversight arrangements and
- how firms had acted upon the Dear CEO letter sent out in June 2011

The Results

2.8 We were encouraged to find good practices at a number of firms that have recognised the potential risks that poor suitability outcomes can pose to their customers, their reputation and market integrity overall. Disappointingly, we also uncovered a number of poor practices and are working with firms to ensure they undertake action in the areas of concern and that they are aware of the need to raise standards.

2.9 Among the firms sampled, our findings indicate a variety of results. Broadly, these were:

- a third fell substantially short of our expected standards[11]
- a third need to make some improvements to meet our standards and
- a third raised no substantial concerns

2.10 The results[12] of our 150 customer file reviews across all firms are:

- 34 (23%) indicate a high risk of unsuitability
- 55 (37%) are unclear[13] and
- 61 (41%) show a low risk of unsuitability

10 Controlled function 30: Customer Function. Sometimes referred to as Financial Advisors, Investment Managers or Customer Relationship Managers
11 Our expected standards are set out under the section 'Our assessment approach' within this report, in our June 2011 Dear CEO letter www.fca.org.uk/your-fca/documents/fsa-our-letter-to-wealth-management-firms and the FCA's Handbook.
12 The percentage figures do not add up to 100% due to rounding up or down as relevant.
13 A file will be judged unclear where there is insufficient information for us to make an assessment or the information presented is inconsistent or confusing.

2.11 Overall, these results demonstrate an improvement since our previous work on suitability, with the proportion of high risk or unclear files falling from 79% to 59%. We have seen that some firms have responded to the issues raised in the June 2011 Dear CEO letter and have addressed our concerns about the suitability of investment portfolios. But there is clearly a need for further improvement by many firms, as there are still too many cases where suitability cannot be demonstrated or there is a high risk of unsuitability.

Our response

2.12 All firms in our project sample cooperated fully with the review process and we will be engaging with them on the remedial action they may need to take in response to the concerns we have identified. We are keen to address the issues effectively and in a proportionate way. For example:

- four firms have to take little or no action as a result of our review because they appeared to meet the expected standards
- six firms may be required to devise and implement a plan to remedy the shortfalls we have identified and
- five firms may be required to undertake significant remediation programmes to raise standards and ensure that they can consistently demonstrate the suitability of clients' investment portfolios in future. Some of these exercises may involve us using our regulatory powers such as the appointment of a third party (skilled person) and we are considering the use of our enforcement investigation powers

2.13 We want all firms providing discretionary and advisory portfolio management services to retail customers to review our findings, consider whether any of the issues we have identified apply to their own businesses, and take action where necessary.

Good and poor practice observed

2.14 In the course of carrying out this review, we have observed a number of areas of good and poor practice. We believe it is useful to share these more widely, to provide firms across the wealth management sector with insights and ideas that may help them to deliver suitable outcomes for their customers. We have provided examples in Annex 2 of this report. These examples are not exhaustive and firms may need to meet other regulatory requirements.

3.
Governance and control environment

3.1 We expect wealth management and private banking firms to have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms[14].

3.2 A firm must establish, implement and maintain adequate policies and procedures sufficient to ensure the firm, its managers, employees and appointed representatives (or where applicable, tied agents) comply with its obligations under the regulatory system[15].

3.3 Our work identified that some firms were able to show that their business culture had customer interests at the heart. Chief Executives, senior management (including compliance officers) and other staff within the business clearly expressed a common understanding of how customer interests were paramount in their delivery of portfolio investment management services.

3.4 In contrast, several other firms were not able to demonstrate a culture that kept customer interests central to the delivery of their services.

3.5 For examples of good and poor practice observed relating to this section of the report please refer to Annex 2.

Putting oversight arrangements in place

3.6 We expect firms to have adequate and effective front line control mechanisms that identify and reduce risks to customers. We wanted to understand how firms were proactively monitoring and managing risks and whether this was leading to suitable outcomes. The wealth management industry contains a variety of firms which have differing business models, service offerings, client acquisition strategies, delivery channels, corporate objectives and legacies. So we would not expect them all to have the same oversight arrangements in place. It is a firm's senior management that is responsible for putting oversight arrangements and controls in place that are right for their business needs and ensure good outcomes for their customers.

3.7 Our observations were that most firms that we visited as part of our review have arrangements in place to monitor and manage risks to customers. In some firms, the arrangements appeared to work as intended, but in others, there were shortcomings in the practices and the outcomes we saw.

14 SYSC 4.1 General requirements www.handbook.fca.org.uk/handbook/SYSC/4/1.html
15 SYSC 6.1 Compliance www.handbook.fca.org.uk/handbook/SYSC/6/1.html

Carrying out effective monitoring

3.8 We expect that, as part of its approach to monitoring, a firm should review how the overall investment portfolio meets the customer's circumstances, risk profile, objectives and expectations. Otherwise, firms may not be able to detect whether customers are at risk of being provided with an unsuitable investment portfolio.

3.9 We noted that most firms' compliance functions would periodically review suitability from a sample of cases in addition to the control mechanisms they had in place at the front line.

4. Suitability – detailed findings

Assessing the risk a customer is willing and able to take

4.1 As explained in the Finalised Guidance in March 2011[16], *'firms should ensure that, in particular:*

- *they have a robust process for assessing the risk a customer is willing and able to take, including*
  - *assessing a customer's capacity for loss*
  - *identifying customers that are best suited to placing their money in cash deposits because they are unwilling or unable to accept the risk of loss of capital*
  - *appropriately interpreting customer responses to questions and not attributing inappropriate weight to certain answers*
- *tools, where used, are fit for purpose and any limitations recognised and mitigated*
- *any questions and answers that are used to establish the risk a customer is willing and able to take, and descriptions used to check this, are fair, clear and not misleading*
- *they have a robust and flexible process for ensuring investment selections are suitable given a customer's investment objectives and financial situation (including the risk they are willing and able to take) as well as their knowledge and experience*
- *they understand the nature and risks of products or assets selected for customers and*
- *they engage customers in a suitability assessment process (including risk-profiling) which acts in the best interests of those customers'*

4.2 Also, as explained in the Finalised Guidance in March 2011[17], *'firms using risk-profiling questionnaires or tools place varying degrees of reliance on the outputs. Where they are used within a suitability assessment process, tools and questionnaires can help to provide structure and promote consistency and so can usefully support the discussion a customer has with their adviser or investment manager.*

16 Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection www.fca.org.uk/static/documents/final-guidance/fsa-fg11-05.pdf, paragraph 1.22
17 Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection www.fca.org.uk/static/documents/final-guidance/fsa-fg11-05.pdf, paragraphs 3.9 to 3.11

4.3 *However, tools may not provide the right answer in all circumstances. So where firms rely on tools, they need to ensure they consider this risk and actively mitigate any shortcomings or limitations through the suitability assessment and 'know your customer' process.*

- *If a firm relies on the automated output from a tool, it is important that:*
- *the tool is fit for purpose*
- *it is used only in the circumstances, and for the target market, for which it was designed*
- *users understand how the tool works and any limitations of the outputs it generates, including to what extent the tool will help them meet their regulatory requirements and*
- *the customer is able to understand and engage with the process as designed'*

4.4 Our review identified that a number of firms were assessing the risk a customer was willing and able to take and this was clearly recorded on file. However, we noted that in a significant number of firms, a customer's attitude to risk was not clearly recorded on file. Where firms used a risk questionnaire to gather information, we saw many examples of customers who gave conflicting or inconsistent responses on their risk appetite or capacity for loss. Often, files did not contain any evidence that there had been a discussion with the client to resolve inconsistencies and clarify the client's true attitude to risk. As a result, for example, we saw clients who had stated that they did not wish to put their capital at risk having portfolios consisting almost entirely of equity investments.

4.5 If firms are in doubt about how to comply with our requirements in this area, they should refer to the 'FSA's Finalised guidance Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection, March 2011[18]'. This guidance is relevant to firms providing investment advice and/or discretionary management services to retail customers.

4.6 For examples of good and poor practice we saw in this area please refer to Annex 2.

Updating and recording customer information

4.7 We expect firms providing advisory and discretionary portfolio management services to be able to show that the key customer information they use to assess the suitability of the portfolio has been kept up to date and is not manifestly out of date.

4.8 COBS 9.2.2R identifies the customer information that firms must collect and consider when assessing suitability in relation to discretionary and advised managed portfolios for retail customers.

4.9 Our review showed that a number of firms periodically contacted customers, for example annually, in order to update the information they held so they could check whether the underlying investment portfolios remained suitable.

18 www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg11-05

4.10 Some firms had made efforts to update customer information but indicated that in a number of cases where they had tried to update information customers had not responded. This creates a risk as firms cannot ensure that individual decisions to trade continue to be suitable. Firms should have an agreed policy on how to deal with these customer portfolios, taking into account the best interests of the individual customer. Firms should retain records to demonstrate the efforts they make in updating customer information.

4.11 We were concerned that in a number of assessments there was limited information to show whether customer information had been updated, or the firm had attempted to update it, for several years.

Making sure portfolios are consistent with the customer information

4.12 We expect firms to ensure that the customer information they gather and record matches the underlying investment portfolio and that they are in a position to demonstrate this.

4.13 We were encouraged that a number of firms had improved the customer information they gathered and recorded, which appeared to support the underlying investment decisions. Some firms appeared to have made these improvements since we issued the Dear CEO letter in June 2011 referred to earlier in this report.

4.14 In many of the files we reviewed, however, we were concerned that the investment portfolios did not seem to match customers' knowledge and experience, financial situation, risk profile and investment objectives. This inconsistency was a significant factor in many of the assessments in which we judged that customer portfolios had a high risk of being unsuitable, or where we were unable to determine whether the portfolio was suitable.

4.15 Some of the key issues observed related to:

- failures to update customer information periodically, resulting in out-of-date and inadequate customer information
- investment managers using a risk categorisation methodology that conflicted with the firm's own customer risk profiling
- investment allocations being made that did not accord with the customer's expectations and / or match the customer's attitude to risk
- no clear rationale recorded for investment allocations and
- no evidence on discretionary and managed advisory customer files to explain the lack of diversification within the portfolios

4.16 We regard these failings as significant due to the high potential for unsuitability and the potential impact this could have on customers.

Turnover

4.17 We expect firms to be able to show that the transactions executed within a customer's investment portfolio over a period of time are suitable and have been carried out in the best interests of the customer.

4.18 A series of transactions that are each suitable when viewed in isolation may be unsuitable if the recommendation or the decisions to trade are made with a frequency that is not in the best interests of the customer. A firm should have regard to the customer's agreed investment strategy in determining the frequency of transactions[19].

4.19 We were unable to determine whether the portfolio turnover was in the best interests of the customer in around 20% of the cases we reviewed. In most cases, this was because a substantial number of trades had taken place during the period under review, without any explanation given in the customer file.

4.20 Firms need to recognise that the existence of transaction charges creates an inherent conflict of interest. Under our rules, firms are required to take all reasonable steps to identify conflicts of interest that may arise between: the firm and a client; or one client and another client. Our rules[20] specifically state that when identifying conflicts of interest, firms should, among other factors have due regard to whether the firm is likely to make a financial gain, or avoid a financial loss at the expense of the client. This conflict of interest is particularly relevant in the context of executing orders and the associated revenue that these can generate for the firm. This risk will be increased if there is an additional incentive within individual staff remuneration structures to generate activity on customers' portfolios.

4.21 Firms should satisfy themselves that they are meeting their obligations in relation to COBS 2.3.1R[21] (inducements rule) and Chapter 10 of the Senior Management Arrangements, Systems and Controls sourcebook (SYSC 10)[22].

4.22 Our rules also require firms to maintain effective processes and procedures to manage any conflicts of interest, such as those identified above, that may give rise to a material risk of damage to the interests of its clients. This is an obligation that falls to all employees with ultimate responsibility resting with senior management.

4.23 In addition, firms must also establish, implement and maintain a comprehensive conflicts of interest policy that is relevant to its business. Firms are required to provide their retail clients with a description of the conflicts of interest policy which they can provide in summary form[23].

Client reporting[24]

4.24 Clearly set out periodic reports provide vital information to customers with discretionary accounts. We expect wealth management firms to send their customers periodic reports that are clear, fair and not misleading so customers can judge whether their investments are being managed well and in line with their expectations, and if they are getting value for money.

19 COBS 9.3.2G www.handbook.fca.org.uk/handbook/COBS/9/3.html
20 SYSC 10.1.4 www.handbook.fca.org.uk/handbook/SYSC/10/1.html
21 COBS 2.3.1 www.handbook.fca.org.uk/handbook/COBS/2/3.html
22 SYSC 10 Conflicts of interest www.handbook.fca.org.uk/handbook/SYSC/10/1.html
23 COBS 6.1.4 www.handbook.fca.org.uk/handbook/COBS/6/1.html
24 COBS 16.3.1 www.handbook.fca.org.uk/handbook/COBS/16/3.html

4.25 We identified client reporting issues, such as firms inadequately disclosing fees and charges within the periodic reports. COBS 16 Annex 2R (4)[25] states periodic reports must include *'the total amount of fees and charges incurred during the reporting period, itemising at least total management fees and total costs associated with execution, and including, where relevant, a statement that a more detailed breakdown will be provided on request'.*

4.26 Our review identified issues in this area across a number of firms that formed part of our sample. For example, a periodic report stated the investment management charge upfront under fees and charges but did not include a total of all of the transaction charges. Numerous transaction charges were detailed individually within the acquisitions and disposals section of the periodic report, but were not aggregated and stated as a total figure. As a result, the total amount of fees and charges did not appear clear, fair and not misleading.

4.27 Periodic reports should also include a comparison of performance during the period covered by the statement with the investment performance benchmark (if any) agreed between the firm and the customer. In one firm we noted that the periodic report stated the FTSE 100 and All Share index prices without detailing how they have changed. In this example, the customer would not have been in a position to make a comparison of the performance of the portfolio with the benchmark.

25 COBS 16 Annex2R www.handbook.fca.org.uk/handbook/COBS/16/Annex2R.html

Annex 1
Relevant rules, guidance and reference material

1. Dear CEO letter June 2011
www.fca.org.uk/your-fca/documents/fsa-our-letter-to-wealth-management-firms

2. The FCA's approach to supervising wealth management and private banking firms
www.fca.org.uk/news/wealth-management-private-banking-approach

3. FSA's Finalised guidance Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection, March 2011
www.fca.org.uk/your-fca/documents/finalised-guidance/fsa-fg11-05

Final notices

4. FSA Final Notice 2012: Savoy Investment Management Limited
www.fca.org.uk/your-fca/documents/final-notices/2012/fsa-final-notice-2012-savoy-investment-management-limited

5. FCA Final Notice 2013: J.P. Morgan International Bank Limited
www.fca.org.uk/your-fca/documents/final-notices/2013/fca-final-notice-2013-jp-morgan-international-bank-limited

6. FCA Final Notice 2014: Santander UK Plc
www.fca.org.uk/your-fca/documents/final-notices/2014/santander-uk-plc

FCA Handbook

7. COBS 2.1.1 The client's best interests rule
www.handbook.fca.org.uk/handbook/COBS/2/1.html

8. COBS 2.2.1 Information disclosure before providing services
www.handbook.fca.org.uk/handbook/COBS/2/2.html

9. COBS 2.3.1 Rule on inducements
www.handbook.fca.org.uk/handbook/COBS/2/3.html

10. COBS 9.2 Assessing suitability
www.handbook.fca.org.uk/handbook/COBS/9/2.html

11. COBS 9.3.2 Churning and switching
www.handbook.fca.org.uk/handbook/COBS/9/3.html

12. COBS 16.3.1 Periodic reporting, Provision by the firm and contents
www.handbook.fca.org.uk/handbook/COBS/16/3.html

13. COBS 16 Annex2R Information to be included in a Periodic report
www.handbook.fca.org.uk/handbook/COBS/16/Annex2R.html

14. SYSC 10 Conflicts of interest
www.handbook.fca.org.uk/handbook/SYSC/10/1.html

Annex 2
Our observations of good and poor practice

This is a summary of some of the good and poor practice that we observed during the review. Firms that are providing retail discretionary and advisory investment management services may want to consider how their arrangements measure up against these examples. The individual examples listed in this Annex are from a variety of firms within our sample and are not derived from one firm or file, unless otherwise stated.

	Good practice	Poor practice
Governance and control environment	In a number of firms the CEO was an active member of the Compliance committee which had responsibility for monitoring portfolio suitability. At some of these firms the Head of Compliance attended the Executive Management Committee which was responsible for key aspects of risk management of the business. This showed a close working relationship between compliance and senior management. The Board of a firm recognised a gap in their collective experience so brought in a dedicated Non-Executive Director with wealth management experience, who provides advice and challenge on the firm's delivery of its services. This contributed to the firm mitigating the risk of delivery of unsuitable investment portfolio to its customers. A firm sought help from third parties, as it wanted some independent input, when testing an existing customer risk questionnaire and then developed the new customer risk profiling tool that is less subjective and better models a customer's risk appetite.	One firm's senior management had overseen a significant back book review over the past several years to address gaps in the information it had on its customers to demonstrate the suitability of its customer investment portfolios. While it had taken this step, it did not appear to have remedied the root cause of the issue. The firm's own recent review of a sample of files and our review of a sample files appeared to show ongoing issues with the quality of customer information recorded to demonstrate suitability. The CEO of one firm struggled to describe the culture within the firm. They appeared to be overly focused on IT-based control mechanisms within the first line of defence to mitigate the risk of customer portfolios departing from their agreed mandate. Insufficient consideration was given to other potential risks, such as the portfolio not being suitable in the first place. Our review of a sample of files showed ongoing issues with the quality of customer information recorded within this firm. It therefore appeared that senior management's approach to embedding a compliant, customer-focused culture within the firm was ineffective.

	Good practice	Poor practice
Putting oversight arrangements in place	In one firm the senior management had put in place a control mechanism to ensure customers' investment portfolios remained suitable. They had a member of compliance staff embedded in front office (ie first line of defence) ensuring that customer information had been updated at least every 12 to 18 months. As well as monitoring the process of refreshing client information, this person actively assisted front line staff eg in producing client-facing correspondence. Our assessments of this firm's files showed no significant issues with the recorded customer information. One firm had embedded a control mechanism where individual investment transactions for a customer must be authorised by another independent investment manager (four eyes rule). The same firm had adopted a weekly peer review of a sample of customer portfolios.	The monitoring process at a firm did not check that the system put in place to remind investment managers to update client information had been acted upon, unless a file was included in a periodic sample review. Our assessments of this firm's files showed issues with the recorded customer information.

	Good practice	Poor practice
Carrying out effective monitoring	One firm recognised itself that it needed help to understand whether it was carrying out effective monitoring. They engaged the services of an external professional compliance consultant to raise their standards of monitoring and, in turn, the suitability of the investment portfolios they manage for their customers. One firm conducted a quarterly outcomes analysis across portfolios that sought to identify outliers on performance and volatility. This provided useful information that allowed the firm to identify whether particular portfolios were not performing in line with expectations, which might not have been picked up through individual file reviews.	We noted that two firms did not undertake monitoring of suitability within customer investment portfolios by the compliance function, independently of the first line of defence. The results of most of the assessments we undertook for these firms were unable to demonstrate whether the customer portfolio was suitable.

	Good practice	Poor practice
Keeping customer information up to date	A number of firms demonstrated that they regularly updated the customer information held on file by proactively contacting customers. Some firms showed they had systems in place to support this process.	Some firms had not regularly updated customer information, and in some instances the information had not been updated for several years and appeared out of date. Customer information that is significantly out of date may create a risk of portfolios becoming inconsistent with a customer's risk appetite and or objectives (or other relevant customer needs) and resulting in an unsuitable portfolio. A client relationship manager displayed a negative attitude to keeping customer information up to date, including information on the customer's risk appetite, telling the customer that it was a burdensome regulatory requirement rather than something that the firm needed to ensure it delivered a suitable portfolio to the customer.

	Good practice	Poor practice
Investment objectives	A firm was able to clearly demonstrate its customers' objectives across all of the files we reviewed. For example, the information on file included the level of income needed and the frequency of payments to be made. The firm also documented clearly when the payments had been made. It was also noted that, where the firm believed that the income levels desired by a customer were not achievable from the investment portfolio, taking into account the customer's own risk appetite, it would discuss this further with the customer.	A customer's objective was recorded as both growth and income. However, it was unclear what level of income was needed and how regularly the income was to be paid. There was contradictory information on file. A file note stated that there was no specific purpose for the portfolio and there was no specific investment time horizon. However, other information on file indicated that the customer relied on a specific amount of income every year from the portfolio to supplement other income.

	Good practice	Poor practice
Risk appetite	In a number of cases we reviewed it was noted that firms reviewed a customer's risk appetite annually. For example, they had annually updated the information held on file and considered whether any adjustments were necessary to the portfolio. Where it was identified that a customer's risk appetite resulting from the output of a risk questionnaire should be further explored because the customer gave conflicting information, a number of firms would discuss this further with the customer. We noted that the final risk appetite in these cases would be adjusted appropriately and agreed with the customer. In one case it was clear that a customer accepted a very substantial risk of loss to achieve financial return and was comfortable with high volatility.	The information on one customer's file confirmed that she could not sustain any loss of income and capital. The firm wrote to her requesting that she reconsider and subsequently increased her risk appetite and the risk of her investment portfolio accordingly. It was unclear why the firm persisted in this way and this may have resulted in an unsuitable portfolio. There were significant inconsistencies in the information held on a customer's risk appetite and no indication that the customer was approached to resolve these. The customer's completed risk questionnaire indicated a medium-high risk appetite. However, it appeared this was changed to a lower risk appetite by the client relationship manager without reason. One firm had elderly customers, including one over 90 years' old, who were documented as having a medium risk appetite and 20 year investment horizon. The firm did not appear to have sense checked this information. These customers' investment portfolios consisted mainly of direct holdings in equities, which may not have been suitable. One firm appeared to be adjusting its clients' documented risk appetites to meet the risk profile of their existing investment portfolios. In one instance, the investment manager attempted to justify this on the basis that costs would be entailed in moving the portfolio to the lower risk profile originally selected by the customer. It appeared from an initial risk questionnaire, for a joint discretionary account, that one of the customers had little or no input to it, indicating the firm may have failed to explore both customers' risk appetite when determining the risk profile for the joint account. There was little detailed information held on a customer file about the customer's risk appetite and no indication that the customer information had been updated between the customer taking up the service in October 2010 and our requesting the file, 4.5 years later. The information was contradictory, including unresolved issues arising from the answers to the customer's risk profiling questionnaire. No records were kept of numerous meetings that apparently took place during this period. The customer's risk appetite as of March 2015 was low-medium, which was difficult to reconcile with a portfolio containing over 90 per cent equities and in the absence of any agreed investment strategy with the customer.

	Good practice	Poor practice
Matching the customer's portfolio with risk appetite	A customer's periodic report indicated differences to the relevant in-house target model where it was underweight in European equities and overweight in cash. However the firm monitored and documented the deviations from the house model clearly showing it had a mechanism in place to manage the risk. A customer had a high risk appetite and was invested accordingly. It was noted the customer had other significant assets. The file clearly recorded that the customer's portfolio managed by the firm was to be managed in isolation to the customer's other assets. A firm had several investment house models to meet different customer objectives and risk profiles. It was clear across all files that the firm was managing its customer investment portfolios in line with the house model asset allocations.	A customer's portfolio held a high proportion of cash holdings. The file contained no explanation why this differed from the model portfolio approach the firm generally adopted or the target allocation. The customer indicated on the risk profile questionnaire that they had an aggressive outlook in relation to risk; however, this appeared to have been overridden without clear justification to a balanced risk profile. Neither of these risk classifications appeared to match the customer's investment holding. A firm adopted a target allocation for its balanced risk investors. The target allocation appeared to be up to 10% AIM/small cap securities and 50% FTSE 350. It was unclear what the remainder of the investment portfolio should contain within this risk profile. In a case where a customer was assessed as having a balanced risk profile the investment portfolio contained 100% equities. It was noted that clients held other investments / assets. However, it was unclear from the information on file whether the customers' portfolios should be managed in isolation of other investments. It was therefore unclear if the firm should take account of these other investments / assets in respect of a customer's overall objectives and risk appetite. It could not be demonstrated what the impact was on the overall suitability of the investments customers held with the firm. For example, concentration risk in asset classes, geographic regions and individual investments could occur, in the absence of detailed information.

	Good practice	Poor practice
Investment time horizon	In a number of cases we reviewed it was noted that firms had annually reviewed a customer's investment time horizon.	In a high number of cases we reviewed, the customer's investment time horizon had not been recorded. A number of firms did not appear to gather information about the length of time customers wanted to invest for. This information was a key element which led us to assess a number of cases as unclear. A customer was 84 years old at the time of opening a discretionary portfolio management account. The file recorded the customer as having a 10 years plus time investment time horizon. The firm did not appear to explore the customer's investment time horizon further or gather information on the health of customer. It was recorded on one file that a customer might wish to buy a property as a possible future objective. The file did not contain information on the customer's investment time horizon and it was unclear if the customer would need access to the funds in order to help with the purchase of the property.

	Good practice	Poor practice
Restrictions on portfolios	Some firms embedded technology controls to manage the risk of customer restrictions being breached.	At the time a customer had agreed to open a discretionary portfolio management account, the information on file indicated no restrictions were to be applied to the investment types to be held within the portfolio. Three years later it appeared that a restriction was placed on the account that no investments in armaments were to be held in the account. One year later an internal file note indicated the portfolio had no restriction applied to it. It was therefore unclear whether a restriction was to be applied.

	Good practice	Poor practice
Capacity for loss [26]	In a number of cases we reviewed it was noted that firms had reviewed a customer's capacity for loss annually.	Many firms within our sample had failed to demonstrate from the information on file whether they had considered a customer's capacity for loss.

	Good practice	Poor practice
Turnover	One firm's transactions showed annual turnover ranging from 4% to 35% across all of the files that we reviewed which appeared suitable and in the customers' best interests. It was noted the firm did not apply transaction costs and rebated commissions received from third parties to the customer accounts. This helped the firm to show how it managed the conflict of interest that can arise when firms generate income from transaction charges.	One firm's transactions showed different levels of turnover across all of the files, which ranged from 47% to 196%. It was unclear why the frequency of transactions was necessary and whether these were executed in the best interests of customers. In this case the firm earned revenues from this activity.

26 By 'capacity for loss' we refer to the customer's ability to absorb falls in the value of their investment. If any loss of capital would have a materially detrimental effect on their standard of living, this should be taken into account in assessing the risk that they are able to take.

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