Financial Services Guidance Note No. 3

Financial Services (Investment & Fiduciary Services) Act 1989
Financial Services (Markets in Financial Instruments) Act 2006

Dealing with and Advising Clients

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Introduction

The following is intended to provide guidance to firms providing investment advice and investment services for clients, primarily in respect of packaged products. This includes insurance intermediaries authorised to sell life assurance based investment products and recognised collective investment schemes, including banks and investment firms holding a class II(b) Life Assurance and Collective Investment Scheme Intermediary and class IV Investment Adviser licence under the Financial Services (Investment & Fiduciary Services) Act 1989, as well as banks and investment firms authorised under the Financial Services (Markets in Financial Instruments) Act 2006.

Firms are reminded of the FSC's powers to seek restitution under Section 42 of the Financial Services (Investment & Fiduciary Services) Act 1989 ('the 89 Act') where it is discovered that customers have been provided with inaccurate information or advice and where a particular product sold was unsuitable for the client. Firms should also be aware of the potential exposure they open themselves up to under Section 43 of the 89 Act which provides for action for damages instituted by clients.

Prospecting for Clients – Unsolicited calls

Unsolicited calls are personal visits or telephone calls which have been initiated by the adviser or firm and not the customer. If a firm wishes to make such calls they must act in accordance with the Financial Services (Unsolicited Calls) Regulations which require that:

1. A firm must ensure that its advisers do not make unsolicited calls unless the firm or adviser has an established customer relationship with the person called on and that customer envisages such calls or the call relates to either a life policy or units in an authorised or recognised collective investment scheme.
2. In making an unsolicited call the adviser should ensure that they first give the customer sufficient information in relation to their identity and that of the firm they represent and also establish whether the customer wishes to proceed.
3. The absence of explicit confirmation should not be construed as signifying consent to receive an unsolicited call.
4. The adviser or firm should likewise in the course, or by way, of an unsolicited call not induce the customer to enter into an agreement, or invest in a particular product without the customer having been allowed a time period after such a call in which they may consider whether they wish to act on the advice provided and invest in the product.

It is of utmost importance that an adequate record is maintained on file of all meetings and correspondence with the client. This includes records of initial visits to, for example, a client's home or place of work and any other unsolicited call. The Commission recommends that firms make use of file notes for these purposes.

Client Questionnaires – Use of a Fact Find

As we have previously advised, it is imperative that advisers obtain as much information about a client and seek to establish a client's financial standing, background (such as experience of the products being advised on) and investment requirements (including attitude to risk) to assess whether a product is suitable. The fact find enables the adviser to give the best advice and offer the product most suited to the client's needs – it is the main tool for getting to 'Know the Customer'.

The fact finding exercise needs to include a thorough and proper assessment of a client's risk profile in terms of impact and likelihood. What this means is that it is not sufficient

to solely record a particular client's attitude to risk in terms of 'high – medium – low' or 'adventurous – balanced – conservative'. It is necessary to establish a client's attitude to risk and how this links to the recommendation of a specific product, taking into consideration the client's stated objectives and needs. Correctly identifying a customer's attitude to risk is a complex task and should not be relegated to a box-ticking exercise or asking the customer for their own self assessment. Few customers will be able to so without considerable assistance. The risk profile therefore needs to be clearly recorded **and** clearly explained to the client. The experience and financial awareness of a customer needs to be taken into account and these factors are particularly important when evaluating a customer's risk profile and when explaining the potential benefits and risks of a particular product.

In particular where a client may be exposed to the loss of his/her entire investment or the possibility of being required to invest further this must be clearly explained to the client documented.

Whilst FSC Newsletter Number 5 of 1992 provided guidance in respect of fact find questionnaires and the contents of these, in addition to the more general questions covered there, a fact find must include the following:

- The client's stated investment objectives and requirements.
- The client's risk profile.

The fact find should be signed by the adviser and the client and where the client has declined to provide certain details this should be clearly recorded on the document and ideally the client should be asked to initial these entries.

A file note recording the details of the meeting with the client should accompany the fact find. Likewise, as highlighted above, similar notes recording subsequent meetings should also be maintained on file. Essentially the fact find, and any other records, must be adequate and satisfactory.

An adviser should also ensure that information provided previously is still accurate when providing supplementary advice at a later date.

'Reason Why' Letters

A 'Reason Why' letter or suitability report is essentially a statement of the advice given and the reasons for it. This should explain why it has been concluded that the recommended product(s) is suitable for the customer having regard to the personal and financial circumstances of the client. It should clearly state the objectives of the client, explaining why the client's needs, priorities, risk profile and financial situation all combine to make the recommended product(s) suitable. It should not therefore merely state what product is being recommended without linking this to the customer's personal circumstances.

The letter or report should contain a summary of the main consequences and any possible disadvantages of acting in accordance with the recommendation and should also include brief details of alternative products recommended but rejected by the customer as well as mentioning issues not discussed because the client may have declined to provide relevant information or because the client specifically expressed no interest in these matters. The document should also include why a particular product provider has been recommended e.g. product features not available elsewhere, price, service levels, performance track record, reputation, financial strength.

A firm should endeavour to make the letter or report simple, concise and clear and above all use plain English. Where any technical terms are used these should be explained if it is unlikely that the customer will understand their meaning.

The document enables the client to understand more clearly the matters discussed at initial meetings and sets out plainly in writing the needs of the client and how these needs will be met by the product(s). It is therefore imperative that it clearly shows why a particular product is appropriate for the client. The client should be asked to read and sign a copy, which should then be maintained on file.

If there is any doubt about whether the customer has fully understood the product, its characteristics or any of the risks involved, this is a convenient medium to use to once again provide a full explanation about the product. It is imperative that customers are aware of what exactly they are investing in, and it is important that a customer taking out, for example, a life assurance based savings product understands, where this is the case, that the product's underlying investment is mainly in stocks and shares and that therefore fluctuations in the value of these will have an effect on the value of the policy. Likewise if the right to withdrawal (i.e. a cooling off period) does not exist the customer must be informed of this and the letter may be a suitable medium in which to provide this information.

The Commission considers that the use of 'Reason Why' letters or suitability reports should be an integral part of the process and firms are therefore required to implement the use of these, if not already doing so.

A 'reason why' letter or suitability report, to be successful, should explain simply and clearly why the recommendation is viewed as suitable having regard to the customer's:

(a) personal and financial circumstances;

(b) needs and priorities identified through the fact finding process;

(c) attitude to risk in the area of need to which the recommendation relates.

The style and presentation of the letter or report is left for firms to decide so that they can design a document which works best for the market in which they transact business. The document is more likely to be effective if it demonstrates these features:

(i). personalisation - the more personalised the suitability letter, the more effective it is likely to be;

(ii). simplicity and plain English - when technical terms need to be incorporated, they should be explained if the customer is unlikely to understand their meaning;

(iii). concise and clear messages - lengthy explanations in extensive letters are likely to reduce the effectiveness of the letter with the customer disinclined to read it properly.

Ideally each letter or report will be different, reflecting the approach of the adviser, the customer's profile, subjects discussed and the considerations on which the advice was based. Firms may wish to introduce a degree of standardisation to its production and when using a standardised approach should take the following into account:

(1) standard paragraphs are best limited to the description of the most common needs and the products which will satisfy those needs;

(2) the firm should clearly link the customer's own needs, priorities and attitude to risk to the product recommended rather than just setting out motives that may apply to all customers;

(3) tick box, pre-printed forms should rarely be used, and when they are it should only be in the simplest and most straightforward advice situations.

A firm should take the following into account when constructing a 'reason why' letter or suitability report:

(a) it should explain why the customer's needs, priorities, attitude to risk and financial situation all combine to make the recommended product suitable for the customer. It should not merely state what product is being recommended with no link to the customer's personal circumstances;

(b) other needs discussed during the fact find process which the customer does not wish to consider do not necessarily need to be included (although they should be recorded in the fact find), however, these *should* be included if they assist in demonstrating why the product recommended is considered suitable;

(c) alternative products which were recommended but rejected by the customer should be mentioned;

(d) the available options under a contract which have been recommended, whether accepted or rejected, need to be mentioned. The associated benefits and risks of entering into a particular contract need to be set out clearly;

(e) it should include a statement of any disadvantages the recommended product might have, especially where the adviser considers that this may be relevant to the particular customer, and where it may be possible that the customer has not fully appreciated what the product involves. An obvious example is where a relatively unsophisticated customer is exchanging an investment in a product whose cash value is guaranteed, such as a deposit account, for one where capital will be at risk, however low that might appear to be.

(f) firms should include why a particular product provider has been recommended; reasons may include product features not available elsewhere, price, service levels, performance track record, investment prospects, medical evidence terms, reputation and financial strength.

Each 'reason why' letter or suitability report should be signed by the adviser. These should be issued to customers at the time that the recommendation is made or as soon as possible afterwards, to allow as much time as possible for the customer to consider the recommendation before making a final decision or before any cancellation period ends, where this exists. If product literature has not yet been provided to the client, it should be included with the letter or report.

A 'reason why' letter or suitability report is not required if the recommendation is made by a firm acting as the customer's investment manager under the terms of an agreement issued in accordance with the relevant conduct of business Regulations. This requirement may also be waived if the client is a professional or institutional investor – in respect of firms authorised under the Financial Services (Markets in Financial Instruments) Act 2006, firms should also note the requirements that are set out in the Financial Services (Markets in Financial Instruments) Regulations 2007 as well as any guidance notes or Codes of Practice issued under either of these pieces of legislation.

Guarantees and Illustrations

When a firm communicates information to a customer the firm must take reasonable steps to communicate in a way which is clear, fair and not misleading. Firms should for example, avoid highlighting the potential benefits of a product without also giving a

fair indication of the risks involved. Examples of this could be the particular risks associated with the underlying assets in which the product is invested; whether the value of the capital and any income from it might fluctuate; or, that fixed regular withdrawals of income often involve risk to capital which can result in a capital shortfall at the end of the contract. Where prominence is given to an element of a product which is "guaranteed" sufficient details should be provided about the guarantee, and the guarantor, to enable a fair assessment of the guarantee. Equal emphasis also needs to be given to any element which is "not guaranteed".

When information about the past performance of a product is given a suitable caveat drawing attention to the fact that past performance will not necessarily be repeated and is therefore not a guide to future performance must be communicated to the client. Any information on past performance must relate to a relevant and sufficient period (of at least 3 years, and preferably 5 years, of past performance to provide a fair and balanced indication of the performance of the product.

A firm may illustrate how the principal terms of a product apply to a customer. The illustration, however, must be specific to the customer and be relevant to that customer's particular circumstances. Projections should be clearly marked "EXAMPLE" and the customer must be informed that the figures shown in the illustration are not guaranteed and will depend on how their investment grows. The customer must also be made aware of the effect of charges and expenses i.e. that these will invariably reduce the projected figures.

Use of Projection Rates

A firm must ensure that when illustrations are provided based on projection rates that the rates used are consistent with the firm's regulatory requirements and obligations. Projections must be provided using, where this is relevant, all of three appropriate rates – the mid-rate and the two flanking rates – in accordance with the rates which the product provider is required to use by its own supervisory authority for that particular product. The effect of charges at the mid-rate should also be provided.

Where a provider is only required to use two rates by its own supervisory authority these should be used – however, firms should ensure that confirmation of the rates required by that supervisory authority is obtained.

Firms should note, however, that these rates are normally ceiling rates, and lower rates should be used where a firm is of the opinion that it would be misleading not to.

Suitability of Investments

As highlighted, a firm must take reasonable steps to ensure that when an adviser makes a recommendation, that this is suitable for the client, having regard to the facts disclosed by the client and any other relevant facts which the adviser is, or should be, aware of. The adviser must therefore make sure that the product is the most suitable of those available and should have an adequate knowledge of, and taking account of, the products generally available from the market as a whole. An adviser must not make a particular recommendation if they ought reasonably to be aware of another available product which would be more appropriate to the needs and circumstances of the client. If there is no product available that will meet the needs of the customer then the adviser should communicate this to the client and at all costs must refrain from recommending an unsuitable product merely because there is no other alternative available. It is imperative that advisers recommend only those products which are appropriate for each customer.

Firms should also ensure that advisers are fully conversant with the products they advise upon and should themselves consider whether they concur with the risk a particular product has been categorised as by a third party (e.g. the product provider).

Advising on pension products

A pension is very often one of the biggest investments most people make, as retirement can last for over 20 or 30 years. This section sets out what firms must ensure they comply with when providing advice in relation to pension products.

A firm must only recommend that a customer acquire a pension product if:

(a) it has taken reasonable steps to assess the customer's circumstances, their understanding of their own retirement needs, and any other information and facts disclosed by the customer;
(b) it has, having due regard to the information in (a), reasonable grounds for believing that the pension product is suitable for the customer; and
(c) the firm reasonably believes that the customer understands the advice he has been given and the basis on which it was provided.

Questions, statements and warnings provided to a customer should be short, simple and couched in plain language that customers will understand. Questions should address one issue at a time.

The sales process should enable the customer to exit freely and without pressure at any stage and should make provision for the adviser to terminate the process if at any stage it appears that there is no likelihood of any product being suitable for the customer (whether by reason of the affordability of products for the customer, the need to address other financial priorities, the mis-match of risk or otherwise).

Where necessary the sales process should incorporate procedures to allow uncertainties in the customer's answers to be addressed before proceeding further and should generally reflect caution about proceeding further. This should incorporate, as a minimum, procedures to reflect the following two scenarios:

(a) If clarification or further information cannot be obtained during the process (this would be likely to be the case for example if a customer were unable to confirm whether he or she was eligible for membership of an occupational pension scheme);

(b) If it appears that the customer will be likely to be unable to afford a pension;

the sale should be terminated at that stage and the customer given an explanation together with a copy of the fact-find documentation completed to that point.

Part of the process should also include an assessment of the customer's other possible financial priorities such as the need for insurance protection for self or dependants, the need for access to liquid cash to meet an emergency, or, a need to reduce a level of existing debt and, if appropriate, the customer should be given an unambiguous warning about the desirability of meeting those other priorities before making payments to a pension product.

A stronger warning about the desirability of addressing debt as a priority should be given if it appears that the customer is significantly indebted, and particularly where there is a strong indication that such debt commitments may render any new commitment unaffordable in the short-term. For this purpose, a firm should consider

using a threshold or indicator to decide whether a customer should be excluded on the basis of affordability. Examples may include where the customer has (a) annual unsecured debt repayments in excess of 20% of gross annual income or (b) four or more active forms of unsecured credit or (c) has consistently reached his overdraft limit. A firm should review its chosen indicator or threshold regularly to ensure that it reflects prevailing economic conditions and takes account of industry best practice.

A customer's savings and investment objectives, including the period over which the customer wishes to save or invest, should be ascertained and this should include:

- Whether early access to some or all of the amount saved or invested could be important;
- Whether the customer wishes to save or invest for retirement; or
- Whether the customer wants to accumulate a specific sum by a specific date.

A firm should, if it is appropriate, also explain the effect of inflation on long-term savings especially in relation to pensions.

A personal pension should not normally be recommended and instead the customer should be advised to seek alternative or further advice if it appears that the customer:

- has or will have access to an occupational pension scheme; or
- is likely to view income in retirement from state benefits as sufficient; or
- already has a pension to which he or she could make further contributions; or
- wishes to retire within five years.

In addition a firm may also want to advise the customer that there may be more beneficial courses of action than investing in a personal pension (for example joining an occupational pension scheme).

A firm should design its processes with a view to addressing the potential risk that customers may fail to appreciate the significance of questions about their pension provision and should accordingly incorporate a range of questions and information designed to foster the customer's understanding of the issues and to elicit appropriate information.

When providing information about a specific pension product, or a range of pension products, firms should also endeavour to provide the following information:

- Whether the contributions made to a pension will be eligible for tax-relief
- What the tax position of the pension itself is i.e. whether it has been approved by the Income Tax Office
- What the charging structure of the pension is initially and an on on-going basis, for example, if the customer decides to top-up or the amount of the contributions paid is increased
- How increases to contribution are dealt with
- Whether there is a guaranteed annuity
- Whether there are any transfer charges if the customer decides at a later stage to move to another pension scheme
- Whether there are any penalty charges

Advising on products that are linked to the purchase of a property

The purchase of a home is also very often one of the biggest investments most people make. This section sets out what firms must ensure they comply with when providing investment advice in relation to a property purchase, and specifically, the financing of this.

The two most common methods of financing the purchase of a property are currently via an interest-only mortgage (sometimes referred to as an endowment mortgage) or a capital repayment mortgage.

A firm must ensure that where a customer requests financial advice in relation to a property purchase that both of these options are considered and that therefore an illustration of both methods, together with a description of each, is provided.

In doing so, a firm should ensure that:

1 In the case of an interest-only mortgage, where the capital sum borrowed is to be met via the proceeds of an endowment policy or similar, that the following is highlighted:

   a. That the sum assured should be equal or greater than the capital borrowed from the bank or building society;

   b. That the customer will be required to pay the interest accumulated on the capital borrowed as well as the premiums due on the policy;

   c. That at the end of the term, the amount received from the maturity of the policy will be used to repay the balance owed to the bank;

   d. That due to the nature of an endowment policy the amount due at maturity is not guaranteed and that it will be the customer's responsibility to make sure that they have enough money to repay the mortgage at the end of the term, otherwise they could risk losing their home;

   e. That the customer should only consider repaying their mortgage with a savings plan where the return is not guaranteed if they are comfortable with this potential risk.

2 In the case of a capital repayment mortgage, that the following is highlighted:

   a. That the customer will be required to pay both the interest accumulated on the balance of the capital borrowed as well as the capital payments;
   b. That the capital balance due, and the interest due on this, will reduce accordingly during the term of the mortgage;
   c. That the monthly payments will gradually pay off the total amount owed.
   d. That provided that the customer makes all the agreed payments, that the loan will be fully paid off by the end of the mortgage term;
   e. That monthly payments can increase if interest rates rise;
   f. That in some cases, the lender will require that that the customer take out life insurance, payment protection insurance or critical illness cover to ensure that in the event of death, illness, loss of employment or other, the mortgage continues to be paid off;
   g. That even if the lender does not require this, that the customer should consider putting in place such protection if there is no equivalent protection already in place;

h. That the customer should consider repaying their mortgage via this option if they want to be absolutely sure that the loan will be fully repaid at the end of the term.

Firms should ensure that the tax implications and costing of both methods, as well as the tax system under which the client is assessed, is also included.

Changing Existing Investments

Where clients wish to change their existing investments or the firm advises a client to pursue this course of action, this must be clearly documented and recorded. An adviser should not make a particular recommendation, such as advising a client to cancel or surrender a policy and replace with a similar product, solely because this will generate new commission income, without regard to the actual needs and circumstances of the customer.

As above, a 'reason why' letter reflecting the position in respect of changes to existing investments should be issued by the firm.

Acting for Clients

Most firms will endeavour to maintain an ongoing relationship with clients in order to source additional business. Firms must ensure however that when acting for clients in any capacity that the scope and limitations of this service have been made absolutely clear.

It is perfectly acceptable for a firm to advise, and agree with, the customer that a review of their investments should be carried out on a yearly, or more frequent, basis thus giving the firm the opportunity to meet the client regularly. A firm should not, however, inform a client, or give a client the impression, that their investment will be monitored and reviewed on an ongoing basis if this is not the case. Firms should avoid giving clients the impression that, for example, any falls in value will be detected quickly and remedial action will be taken on the client's behalf if this is not the case.

Firms, in the knowledge that values are falling, should contact clients and advise that investments should be reviewed as a result of market conditions. To do so is considered good market practice. Where a firm provides dealing or investment management services, written customer agreements must be in place. Where a firm provides an execution-only service to a client this should also be adequately recorded. The client should be asked to confirm that no advice is required.

Statements & Valuations

Firms providing dealing or investment management services must ensure that contract notes are delivered to customers upon execution and statements and valuations are produced and sent to clients at suitable intervals. Where, for example, insurance intermediaries receive statements or valuations on behalf of clients, firms should ensure that these are forwarded on to the clients without undue delay.

The majority of firms will also correspond with product providers on behalf of the client and agree to provide this as part of their overall service. For example, sending requests for up to date valuations and surrender values, dealing with surrenders of policies or sale of investments etc. Firms should ensure, therefore, that timeliness of delivery is given due attention. The Commission recognises that there are a number of product providers who will not act upon instructions until delivery of original documentation has

been received. Firms should therefore make adequate arrangements with product providers to ensure that satisfactory methods of delivery are established. The client should also be informed of this. The risks which a delay in delivery can result in, such as a potential fall in value, should also be set out clearly.

Advertising and Marketing Material

Firms are required to comply with the provisions of the Financial Services (Advertisements) Regulations 1991. In much the same way as is described above under 'Guarantees & Illustrations' firms must ensure that advertisements are clear and not misleading. The advertisement should be presented in such a manner that is not likely to be misunderstood. Where prominence is given to a particular statement in respect of the product being advertised equal emphasis needs to be given to any other statements of similar significance. For example, if a product allows for regular withdrawals of income and this is highlighted in an advert, the risk of erosion of capital should equally be pointed out. Likewise advertisements should relate to the actual product in its entirety and not solely to any one underlying element of the product.

Advertisements should not include any statement or forecast, for example on the past performance of a product, unless the firm has taken all reasonable steps to satisfy itself that such a statement or forecast is not misleading and is accompanied by the necessary caveat.

Where two or more products are compared and contrasted in an advertisement, the comparisons and contrasts must be fair in relation to the product being promoted and to the alternative i.e. like must be compared with like. An advertisement should not, for example, compare the likely returns on a life assurance product with the likely returns on a bank deposit with no reference to the level of risk to capital involved i.e. capital risk exists with the life assurance product whereas capital is protected with the deposit.

Client Location

Firms are reminded that they must ensure they comply with the local legislation and regulatory requirements in places where they operate. Where firms are in doubt as to those obligations, they should contact the regulator in that jurisdiction or seek legal advice. The Commission can provide contact details of regulators if requested.

Financial Services Commission

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