



**Pensions
Management
Institute**

Learning



Retail Advice and Regulation Study Manual

ABOUT THE PMI

THE PENSIONS MANAGEMENT INSTITUTE (PMI)

Founded in 1976, the Pensions Management Institute (PMI) is the UK's largest and most recognisable professional body for employee benefit and retirement savings professionals, supporting over 6,500 members in 32 countries.

PMI's members, represented in 9 regions, are responsible for managing and advising some of the largest institutions in the world accounting for £1trillion invested in pensions. We promote excellence through a range of services for the benefit of members, the wider economy and with over six million now saving as a result of automatic enrolment, society as a whole.

The purpose of the Institute is "To set and promote standards of excellence and lifelong learning for employee benefits and retirement savings professionals and trustees through qualifications, membership and ongoing support services".

To achieve this, PMI:

- Promotes and embeds professional standards, setting the benchmarks for best practice
- Produces qualifications that have a reputation for excellence and ensure that employee benefits and retirement savings professionals, whether they are scheme managers, consultants, administrators or trustees, are educated to the very highest standards and the latest legislation
- Provides continued lifelong learning designed to strengthen the knowledge and skills of employee benefit and retirement savings practitioners in performing to the best of their ability
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- Presents an annual conference and a wide range of technical seminars from entry-level to those for highly experienced professionals
- Provides industry-leading insight, including Pensions Aspects, PMI TV, Expert Partner insights, newsletters and blogs to keep practitioners abreast of the very latest developments in a rapidly-changing industry
- Proactively has a voice in mainstream and social media with a presence on Twitter and LinkedIn www.pensions-pmi.org.uk

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We are very grateful to Peter for reviewing the text of this edition of the Study Manual.

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FOREWORD

PMI was formed in 1976 to promote professionalism amongst those working in the field of pensions. Today, we are acknowledged as the institute for pensions professionals. We have developed study and examination facilities leading to a nationally recognised qualification – the Advanced Diploma in Retirement Provision. This embraces all aspects of law and practice relating to the management of workplace pension arrangements. The Advanced Diploma is a comprehensive and in-depth qualification for retirement benefit professionals. It is the qualification component for Associateship (APMI) of the Pensions Management Institute (PMI).

The structure of the Advanced Diploma was comprehensively revised for first examination in 2016. This revision was to ensure that the syllabuses were up to date and the qualification continues to meet the needs of users. The Advanced Diploma framework comprises five core units and seven specialist units. To complete the Advanced Diploma students will need to complete eight units as set out below.

The foundation of the qualification is formed of four core units. These compulsory units cover all aspects of retirement provision in the UK, including regulation, administration, financing and investment. There is an additional option covering international employee benefits. The core units are assessed by a two hour examination. The core units are then followed by specialist units. Students choose either, or both, of the Tier 1 specialist units - Defined Benefit Arrangements or Defined Contribution Arrangements as most appropriate for them. Depending whether both or just one of the Tier 1 specialist units are selected either one or two further specialist units can be selected from the Tier 2 specialist options including Reward, Retail Pensions or International Employee Benefits. These choices allow the students to select those areas that best fit their current work or future career aspirations. Finally the Professionalism and Governance Unit must be completed by all Students. All of the specialist units are assessed by 3 hour written examinations.

There are several Diploma level qualifications comprised of units from within the structure of the Advanced Diploma for those who do not want or need to complete the Advanced Diploma. These have also been revised as part of the changes to the Advanced Diploma.

The Diploma in Retirement Provision (DRP) includes all four UK focussed core units and either of the Tier 1 specialist units (Defined Benefit Arrangements or Defined Contribution Arrangements). The DRP would be completed by all those who proceed to complete the Advanced Diploma.

The Diploma in Employee Benefits and Retirement Savings (DEBRS) is ideal for those who need to understand pensions in the wider savings and employee benefits context, and consists of two of the core units and the Tier 2 specialist Reward unit.

The Diploma in Regulated Retirement Advice (DRRA) consists of two Tier 2 specialist units: Taxation, Retail Investment and Pensions; and Retail Advice and Regulation. It is an appropriate qualification for the FCA regulated activity “Advising on Packaged Products” which includes pensions and retirement planning and advising on pensions transfers.

The Diploma in International Employee Benefits (DiplEB) consists of the two internationally focussed units: the Foundation in International Employee Benefits core unit and the Tier 2 specialist unit - Managing International Employee Benefits. These units have been developed in partnership between PMI and the International Employee Benefits Association.

Those who wish to complete the Advanced Diploma can opt to take the units that comprise the DRP, DEBRS, DRRA and/or DiplEB on the way to becoming Associate Members of PMI. Alternatively, those who only wish to sit those Diplomas can become Diploma Members of PMI on completion.

There are many benefits to be gained from studying for, and attaining, these qualifications. These include the body of knowledge and understanding gained and its application to practical situations, a demonstrated commitment to learning and development, and enhanced status, confidence and opportunities for career progression.

Undertaking this rigorous professional qualification places demands on students and we are committed to supporting studies with quality learning provision. Under the banner “Shaping the pensions professionals of tomorrow” we are delighted to be working with some of the UK’s leading companies and firms within the pensions industry who have taken on the role of study support partners. In each unit the study material comprises a study manual and access to a web-based distance-learning course designed to prepare students for the examinations.

Professionalism and Governance seeks to provide an understanding of the importance of professionalism, ethics and continuing their own professional development and to provide an appreciation of risk and governance issues as they apply to pension schemes, and to enable candidates to demonstrate their ability to apply risk and governance principles in a practical situation and that they can communicate their knowledge in a way that is relevant to their audience. The 2021 version of the study manual reflects the Pensions Regulator’s focus on 21st Century Trusteeship and increased focus on environmental, social and governance issues together with updates and guidance from industry standard setting bodies in administration, accounting and governance.

Further details on the other units that comprise the Advanced Diploma and the work of the PMI can be found on the website. We hope you will enjoy studying for the Advanced Diploma. We welcome feedback and this should be directed to the Qualifications Department at PMI, e-mail: qualifications@pensions-pmi.org.uk

PREFACE

The aim of this unit is to ensure that the student develops an understanding of the nature of the regulatory regime which governs the promotion and sale of retail investment products. Investment products, as well as pension arrangements, taxation and State benefits are considered in the other DRRA unit: Taxation, Retail Investment and Pensions.

This manual is split into five Parts with subsequent Parts building on the information contained in its predecessor.

Part 1 covers how the financial regime works, examines the EU legislation from where much of our Regulation has been derived and discusses the work the bodies which are charged with regulating financial services and products. In particular it analyses the responsibilities of the Financial Conduct Authority (FCA) responsibilities and the FCA's approach to regulation. The Part also covers how advisers need to keep records that meet the requirements of the Data Protection Act 1998, describes the complaints procedure and explains, inter alia, the consumer protection role of the Financial Ombudsman Service, the Financial Services Compensation Scheme and other consumer protection bodies.

Part 2 considers professional standards. These are regulated by the FCA which uses both principles and outcomes- based regulation to establish its principles for business, corporate culture and leadership, and to establish the responsibilities for approved persons. This Part summarises the main features of the FCA Handbook and describes the professional principles and values on which its overarching Code of Ethics is based, and goes on to distinguish between ethical and compliance-based outcomes. Finally in this Part we evaluate the importance of professional standards and judgement in establishing and maintaining client relationships, needs and priorities. This includes gathering information which can be analysed so that recommendations can be made to the client.

Part 3 brings together a number of investment concepts that an adviser needs to understand. Some of these have already been covered in Taxation, Retail Investment and Pensions (or its equivalent in the previous syllabus). The concepts covered here include investment theory, investment allocation and performance monitoring. We explain the concept of "know your customer" and asset allocation and place these concepts within the context of investment planning.

Part 4 looks at a number of legal concepts relevant to financial advice of which advisers need to be aware and the ways in which they might affect clients. These include Powers of Attorney, property ownership, bankruptcy and the use of trusts.

Part 5 outlines covers pension transfers and explains how they work in practice. The Part also highlights Self Invested Personal Pensions and drawdown and current pensions issues, such as Pensions Freedom.

On completing your study of this manual, you should have an understanding of regulations applying to retail investment advice. You should be able to demonstrate an understanding of the requirements to gather the information required to satisfy the "know your customer" principles for investment and financial planning and be able to review the advice given to clients on a regular basis.

This study manual has been updated for the examination in October 2019 and April 2020 and will be based on the law as it existed at 6 April 2018 though allowance where possible has been made for later (and proposed) legislation. An awareness of any significant changes after 6 April 2019 will be to a candidate's advantage.

Note: Students will be familiar with the HMRC Rules governing Annual Allowance, Lifetime Allowance, Transitional Protection, etc. from previous studies. Reference should be made to this important background material where necessary.

In this unit, use of masculine words includes the feminine where the context so admits

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SYLLABUS

To develop an understanding of the nature of the regulatory regime which governs the promotion and sale of retail investment products and the application of professional standards and judgement in establishing and maintaining client relationships, needs and priorities.

1. **analyse** the UK's financial services industry within an international context
 - describe** the role and structure of the UK and international markets
 - explain** the impact of EU law
 - define** the role of Government in setting economic and industrial policy
 - explain** the function of financial services within the wider economy
2. **explain** how the consumer is served by the financial services industry
 - describe** the role of the providers of financial products
 - explain** the relationship between product providers, advisers and consumers
 - analyse the perception of financial services
 - identify** the main financial needs and how they are met
3. **understand** the context of the regulation of financial services and the bodies charged with this role and provide assistance or protection to members and employers
 - outline** the role and powers of:
 - Financial Conduct Authority (FCA)
 - HM Treasury
 - Bank of England
 - Competition and Markets Authority (CMA)
 - The Pensions Regulator (TPR)
 - Department for Work and Pensions (DWP)
 - HM Revenue & Customs (HMRC)
 - Pensions Ombudsman Service (including PPF)
 - Financial Ombudsman Service
 - PPF Ombudsman
 - The Pensions Advisory Service (TPAS)
 - Citizens Advice Service (including Citizens Advice Bureau)
 - The Money Advice Service (MAS)
 - Pension Protection Fund (PPF)
 - Financial Assistance Scheme (FAS)
 - National Insurance Services to the Pensions Industry (NISPI)
 - The Information Commissioner
 - The Pension Tracing Service
 - Pensions Compensation Board
 - Pension Schemes Registry
 - Pension Wise

4. **analyse** the FCA's responsibilities and approach to regulation
explain the role of legislation including the Financial Services and Markets Act (FSMA) 2000, MiFID and EU regulation and relevant Directives
describe the FCA's powers and activities
explain financial stability, prudential regulation dealing with financial crime
describe the FCA handbook and business standards, including the conduct of business, rules for dealing with client assets market conduct code, and training and competence
describe the FCA's regulatory processes and risk-based supervision
explain oversight within firms
5. **define** the principles and rules as set out within the regulatory framework
describe the following:
 - regulated activities
 - controlled functions and the responsibilities of approved persons
 - record keeping requirements
 - the concept of professionalism
 - the anti money laundering and proceeds of crime requirements
 - the requirements for data protection**explain** the complaints procedures and the Financial Services Compensation Scheme
6. **analyse** the FCA's use of principles and outcomes-based regulation
explain principles for businesses
explain corporate culture and leadership
describe the responsibilities of approved persons
7. **understand** how companies and individuals working in the pensions field are regulated by the FCA
outline the characteristics of:
 - statements of principle
 - financial advice
 - best advice
 - treating customers fairly
 - advertising and promotion
 - regular reviews of suitability
 - Retail Distribution Review
 - Financial Advice Market Review (FAMR)
8. **understand** the context of the Code of Ethics and distinguish between ethical and compliance-based outcomes explain the over-arching code of ethics and describe the professional principles and values on which the Code is based explain the management of ethical dilemmas and describe typical behavioural indicators
explain outcomes which arise from behaving ethically and those which arise through limiting behaviour to compliance

9. **evaluate** the application of professional standards and judgement in establishing and maintaining client relationships, needs and priorities

explain the importance of:

- gathering information
- analysing circumstances and requirements (including Sharia or ESG requirements)
- making recommendations
- effective communication and disclosure requirements
- cancellation rights
- monitoring and reviewing

explain the concept of know your client and suitability reports

10. **understand** financial calculations and risk

explain the time value of money and the main types of risk

11. **understand** the key features of the main investment theories

describe the following:

- portfolio theory, diversification and hedging
- behavioural finance

12. **understand** the context of investment and tax planning and performance monitoring

describe the following:

- portfolio construction, performance and review
- wraps and other platforms
- management style and charges

13. **understand** the legal concepts relevant to financial advice

explain the following concepts:

- legal persons and power of attorney
- property ownership
- insolvency and bankruptcy

describe the following:

- contract law and agency
- wills and intestacy
- the main types of trusts and their uses and their creation and administration

14. **understand** the concept and practice of pension transfers

describe the concept of a pension transfer and the role of regulation in relation to pension

explain the following:

- the administrative requirements and procedures surrounding pension transfers
- the roles and responsibilities of those involved in pension transfer issues
- the calculation of transfer values
- the concept of transfer incentives and the related legal requirements

analyse the advantages and disadvantages (including scams) of pension transfers and the implications for all parties of pension transfers and the implications for all parties

15. **outline** recent developments in legislation and forthcoming changes that will impact on retail advice involving pension provision

explain the impact of recent developments

PART 1

FINANCIAL SERVICES REGULATION

OVERVIEW

Just over three decades ago, specific financial services regulation as such did not exist. Then, an “adviser” had no need to successfully complete a formal qualification: advice could be offered to clients after a few weeks’ limited training.

In the City, “my word is my bond” was still the traditional tenet by which business was conducted. Trade bodies like the British Insurance Association, the Life Offices’ Association, the National Association of Security Dealers & Investment Managers and the Society of Pension Consultants offered guidance to the industry generally at the corporate level, while professional institutes such as the Faculty/Institute of Actuaries, the Pensions Management Institute (then not a decade old) and the Chartered Insurance Institute offered membership and qualifications to those advisers who chose to show professional commitment.

Annual Statements of Professional Standing were not required by advisers and neither the Personal Finance Society, for example, nor the concept of “compliance” in financial services existed. Even the term “Independent Financial Adviser” was not used: independent advice was given, but by Insurance Brokers who had increasingly become more recognised as acting on behalf of their clients rather than their traditional role as agents of insurance companies. Insurers meantime had substantial direct sales forces selling their products (only) to members of the public. Banks were increasingly seeing investment products as a further way to boost profits and savings products were still sold to the public by home service insurers with premiums being regularly collected in cash, although by that time home service insurance had lost much of its former popularity as its operating expenses were increasingly scrutinised. Specific financial services legislation was still on the Parliamentary drawing board. The Prevention of Fraud (Investments) Act 1958 had in essence re-enacted earlier (1939) legislation to provide limited consumer protection supplementing more generalised legislation, while separate Statutes imposed some controls on the banks and building societies. Insurance companies needed to justify their solvency position annually with returns to the Department of Trade and Industry. But headline cases, where members of the public had suffered losses, were hitting the media from time to time in the 1970s and early 1980s. As we will start to consider in a couple of paragraphs hence, these cases spurred Parliament to legislate.

Headline cases still hit the media today and may well lead to more legislation just as those earlier cases created an irresistible groundswell for financial services legislation. Examples of headlines from the last decade, of which the student is very likely to be aware, include: the 2008 bankruptcy of Lehman Brothers (an organisation founded as long ago as 1850 and part of the American business culture), the American sub-prime crisis (with the questions later asked about what toxic investments did the Americans wrap into their collateralized mortgage packages), the banking crisis which hit UK banks (notably Northern Rock and RBS) and the mis-selling of payment protection policies to bank customers in particular (which issue is still impacting the balance sheets of the major banks). More recently still, problems have been experienced with the funding of BHS and British Steel/Tata pension schemes.

And what does the future hold? The implications of Brexit will be a dominant consideration. But Pensions Liberation Fraud issues will inevitably remain a concern particularly with pensions freedom having fully opened up the individual's pension pot to non-pensions use - though Her Majesty's Revenue and Customs (HMRC), the Pensions Regulator (TPR) and the Financial Conduct Authority (FCA) have this aspect on their radar. Whatever the student's or anyone else's view of legislation, subsequent regulations and the cost thereof, financial services legislation is now here to stay, having been exponentially expanded from its 1980s origins. It was those headline cases over 30 years ago which were the catalyst for initial Parliamentary action. Recurrent headlines today give the legislators (with their eyes on votes, perhaps) and regulators further reasons for intervention.

It is worthwhile considering Parliamentary speeches made when what became the Financial Services Act 1986 was being debated. They reflect how Parliament felt it had to react to financial services problems by introducing new legislation and regulations. Whether further legislation helps or hinders may be a matter for debate. Whatever, there were issues in the 1980s to which Parliament decided to react and they have become part of the regulation of retail investment advice which financial advisers must respect. Hansard on 16 July 1984 records the contemporaneous debates. Peter Shore MP summarised the background at the time:

"The immediate reason for establishing the Gower investigation [see below] was the string of collapses of stockbrokers and investment managers, including such well-known names as Hedderwick, Sterling Gumber Norton Warburg and Halliday Simpson, not to mention the still more serious defaults at Lloyd's that were revealed shortly afterwards. It was that that gave the impetus and occasion for this latest and most searching review of the legislation and machinery for investment protection."

The names quoted by Mr Shore were as well-known then as the more recent names and problems quoted earlier (Lehman etc.). He also summarised the then piecemeal legislation:

"As things now stand, we have an uneven and fragmented system for investment protection. Most of our main financial institutions are regulated by specific Acts of Parliament. Insurance companies are covered by recent legislation, such as the Acts of 1974, 1976, 1980 and 1981, and companies by the 1967 Act and the more recent 1980 Acts. Building societies have not been the subject of serious legislation for many years, while banks have been the subject of more recent legislation, in the form of the Banking Act 1979.

In addition, we have the Prevention of Fraud (Investments) Act 1958, which is of a general nature and seeks to deal with the dangers of irregularities and fraud over a wide area of financial services and markets. There are also a number of self-regulatory bodies or other agencies, with their own constitutions and rules of membership. The Stock Exchange is the most important of these, but the category also includes the take-over panel, the London Metal Exchange, the Gold Futures Exchange and the London International Financial Futures Exchange. There are also those markets - commodity markets come to mind - where self-regulation is either minimal or non-existent."

In the same debate, Gerald Bermingham MP also referred obliquely to the somewhat infamous Dover Plan investment from the 1960s marketed by Bernie Cornfield's Investors Overseas Services (IOS at one time employed 25,000 people, largely in continental Europe):

"How do we prevent fraud? How do we prevent ordinary people from being taken for a ride? It is not often that an institution is taken for a ride. It is usually Mrs. Smith, with her £500 life savings, or Mr. Brown, with his redundancy money ... Who takes them for a ride? It is not a stockbroker, but invariably a door-to-door salesman who comes along with the Bernie Cornfield type of insurance policy and tells the householder how to get rich quickly - "Pay £1,000 a year and in 20 years you will have £300,000 back." Unfortunately, people fall for it."

In the first Hansard extract above, reference was made to the Gower investigation. It was this investigation which first launched financial services regulation and which has now evolved into what we have now with the “help” of other financial crises which have occurred from time to time. In response to the unsavoury events reported in Hansard (and others which were known at the time - such as Slater Walker Securities, an authorised bank which held retail investments and which was taken over by the Bank of England when it got into financial difficulties), the Government appointed the Wilson Committee in 1980 to review the UK’s financial system. The Government was not satisfied with its findings and therefore in 1981 asked a respected corporate lawyer Professor Laurence “Jim” Gower to consider new legislation. His remit involved:

- the level of statutory investor protection
- how investment advice and management advice are controlled
- whether law changes should be made to improve consumer protection
- the relevant developments of the EEC (European Economic Community).

Jim Gower produced his report, *Review on Investor Protection*, in 1982. After a 1984 update, the Government adopted a number of his proposals in a January 1985 White Paper. The Financial Services Act 1986 resulted. It covered investment business and activities carried out in relation to those investments; it applied from A-day, 29 April 1988.

In line with Jim Gower’s proposals (though not adopting the proposals fully in that the self-regulatory approach was largely taken rather than the recommended direct Government regulation), the Act named the Securities and Investments Board (SIB), substantially the forerunner of the FCA, as the agency for supervising UK investment business. The SIB created five Self-Regulatory Organisations (SROs), later condensed to three: The Personal Investment Authority, The Investment Management Regulatory Organisation and the Securities and Futures Authority. These were later subsumed into the Financial Services Authority (FSA - see section 1.2, Chapter 1 of this Part). In addition the SIB also recognised other professional bodies which conducted day-to-day regulation of investment business e.g. the Law Society.

The student can perhaps appreciate from this Overview the background circumstances which resulted in political intervention. A moment’s reflection will also help the student to understand that financial services regulation continues to evolve spurred on by other headline issues. These include: the pensions mis-selling problem resulting in the extensive Pensions Review in the mid-1990s, the misappropriation in the late 1980s/early 1990s of in excess of £400 million from the Mirror Group pensions funds by Robert Maxwell to support his ailing business empires, the effective collapse in October 2000 of the 1762-founded Equitable Life Assurance Society after failing to properly secure its liabilities, the Icelandic banking crisis in autumn 2008, the LIBOR rate-fixing scandal which emerged following a Financial Times article in July 2012. The list can be extended to include other past events and it will be extended in future: the student as a future adviser will need to make sure they are not involved in any misuse of “pensions freedom” perhaps. Perhaps the concerns voiced against Sir Philip Green and his alleged misuse of funds which would have otherwise gone to the ailing BHS pensions fund will reverberate for some time to come? Nowadays however, the FCA (or other regulator) can initiate comparatively prompt action: primary legislation such as the Financial Services Act 1986 is needed only for minor adjustments to regulatory powers and responsibilities.

While the student will not be examined on any facts contained in this Introduction, they do perhaps give insight into why and how financial services regulation, as we now know it, developed. The names may no longer be familiar but the circumstances will have a distinct ring of familiarity. It is certain that the financial services regulation industry will continue to evolve in response to as yet unknown (or little known) issues, irrespective of the impact Brexit will have. Indeed the UK Government has in the past played a significant role in formulating the detail of European Union (EU) legislation to date. The importance of London as a global financial services centre will ensure that our financial services industry continues to maintain its standards and reputation.

In this Part we look at the role of the bodies charged with regulating financial services, including those the adviser will come across in dealing with group pensions rights, and we will analyse the FCA's responsibilities and approach to regulation. We will consider the impact of past EU legislation (incorporated already into UK law and remaining until such time as any amendments may be made – and bear in mind that Norway and Switzerland, not EU members, incorporate EU laws into their own national laws so they can trade with the EU, so future EU Directives may still be adopted by the UK) and we will also see the change in regulatory processes and principles from the risk-based supervision used by the FSA to the judgement based regulation employed by FCA. Note that the FCA Handbook, a very detailed and technical document, consolidates regulatory requirements and contains much of what the FCA expects from advisers and their employers.

We will:

- define the principles and rules set out in the extensive regulatory framework.
- consider the wider requirements imposed on financial institutions to watch out for fraud, especially with regard to money-laundering;
- describe the complaints procedure and the role of the Financial Ombudsman Service and the Financial Services Compensation Scheme;
- describe the record keeping requirements placed on advisers and how these will need to meet the requirements of the Data Protection Act 1998.

CHAPTER 1

The Regulation of Financial Services and Consumer Protection

INTRODUCTION

When looking at financial services regulation, an understanding of the roles of the bodies charged with this regulation is essential. Historically, the financial markets had been controlled by a number of organisations, but significant consolidation of the functions of these organisations has taken place – and that consolidation is ongoing. In this Chapter we look at the roles undertaken by the various bodies currently (including the internal Complaints function) involved, viz.:

- HM Treasury
- Financial Conduct Authority (FCA)
- Bank of England including the Prudential Regulation Authority (PRA)
- Competition and Markets Authority
- The Pensions Regulator
- Pension Protection Fund (and Financial Assistance Scheme)
- Information Commissioner
- Payment Systems Regulator
- Complaints Procedure
- Pensions Advisory Service and the Pensions Ombudsman
- Financial Ombudsman Service
- The Financial Services Compensation Scheme
- Pension Wise
- Money Advice Service.

We will also explain the role of legislation including the Financial Services Act 2012, the Financial Services and Markets Act 2000 (FSMA), the Markets in Financial Instruments Directive (MiFID) and EU regulation. We will also consider how oversight within firms operates.

1.1 HM TREASURY

The UK Government department responsible for the regulation of the financial services industry is HM Treasury, under the authority of the Chancellor of the Exchequer. Therefore each Chancellor will have his own policy agenda in this area.

At a macro level, HM Treasury are responsible for maintaining control over public spending, deciding how money is raised from taxpayers, setting the direction of the UK's economic policy and working to achieve strong and sustainable economic growth. Their policy team advises Ministers and ensures they have the information they need when making decisions.

Their specific priorities are:

- reducing the deficit and rebalancing the economy
- spending taxpayers' money responsibly and ensuring value for money
- creating a simpler, fairer tax system – alongside a well-functioning welfare system
- creating stronger and safer banks
- making corporate taxes more competitive
- making it easier for people to access and use financial services
- improving regulation of the financial sector to protect customers and the economy

In June 2010, George Osborne, Chancellor of the Exchequer, set out his financial services policy agenda in the Budget and his Mansion House Speech. As a result, the Financial Services Act 2012 came into force on 1 April 2013 and introduced changes which have fundamentally changed the way financial services firms are regulated. These included:

- giving the Bank of England responsibility for oversight of the UK financial system as a whole, by establishing a new Financial Policy Committee within the Bank, with powers to ensure emerging risks and vulnerabilities across the financial system as a whole are identified, monitored and effectively addressed
- setting up a new regulator of safety and soundness in the financial services sector, the Prudential Regulation Authority, working under the Bank of England, to supervise all firms that manage significant risks as part of their business: banks and other deposit takers, insurance companies and large investment banks
- establishing a new business regulator for financial services, the Financial Conduct Authority, to protect consumers and supervise all firms to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants, ensuring the industry remains stable and promotes healthy competition between financial services providers
- clarifying the Government's responsibilities in a financial crisis by giving the Chancellor of the Exchequer powers to direct the Bank of England where public funds are at risk and there is a serious threat to financial stability.

As part of the Government plan to create a stronger and safer banking system which supports the economy, consumers and small businesses, HM Treasury have also introduced reforms enacted within the Financial Services (Banking Reform) Act 2013 which represented the biggest-ever overhaul of Britain's banking system. Its stated aim (Press Release from HM Treasury and The Rt Hon Sajid Javid MP published on 18 December 2013) was to transform the banking industry through four key areas of reform:

- supervision: the Government put the Bank of England back at the centre of the supervisory regime, with new powers to identify and address systemic risks as they emerge, ensuring safe banks that will not bring down the economy in the future
- structure: the Government brought forward new laws to separate the branch on the high street from the trading floor in the City to protect taxpayers when mistakes are made
- culture: the Government imposed higher standards of conduct on the banking industry by introducing a criminal sanction for reckless misconduct that leads to bank failure and a more stringent approval regime for senior bankers
- competition: the Government empowered consumers by giving them greater choice, which should incentivise innovation and competition within the banking sector.

1.2 FINANCIAL CONDUCT AUTHORITY (FCA)

In the wake of the financial crisis, which adversely affected economies worldwide in the two to three years from 2008, the Government announced in 2010 that the Financial Services Authority (FSA) would be replaced by two new successor bodies, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). Legislation to effect this change was contained in the Financial Services Act 2012 and came into force on 1 April 2013.

The FCA is a company limited by guarantee. The organisation was incorporated on 7 June 1985 as the Securities and Investments Board Limited and its name was changed on 20 August 1987 to the Securities and Investments Board (SIB). Later, on 28 October 1997, following the merger of banking supervision and investment regulation, the SIB changed its name to the Financial Services Authority (FSA). In June 1998, responsibility for banking supervision was transferred to the FSA from the Bank of England. Its remit was extended further on 1 May 2000 when the FSA took over the role of UK Listing Authority from the London Stock Exchange - the listing rules set out the standards for any company wishing to list its shares or securities for sale to the public.

The Financial Services and Markets Act (FSMA), which was implemented on 1 December 2001, transferred to the FSA the responsibilities of several predecessor organisations.

The FSMA (s118) also gave the FSA responsibility for taking action to prevent market abuse, which may arise in circumstances where the investor is disadvantaged as a result of insider trading or market manipulation. In October 2004, the FSA took on responsibility for mortgage regulation and, in January 2005, the regulation of general insurance business. On 1 April 2013, following the enactment of section 1A of FSMA, the Financial Services Authority was renamed as the Financial Conduct Authority.

The FSA had four statutory objectives:

- market confidence - to maintain confidence in the financial system
- financial stability - to contribute to the protection and enhancement of the UK financial system
- consumer protection - to secure the appropriate degree of protection for consumers
- the reduction of financial crime - to reduce the extent to which it is possible for a business to be used for a purpose connected with financial crime.

The FCA also has the strategic objective to ensure that the relevant markets function well (in addition to the statutory objectives originally set up by the FSMA). To achieve this, it has three operational objectives:

- to secure an appropriate degree of protection for consumers
- to protect and enhance the integrity of the UK financial system
- to promote effective competition in the interests of consumers.

This third objective is a new role, as the FSA had no explicit responsibility for competition. The FCA is required to identify and resolve specific concerns about competition within the marketplace. The FCA operates the prudential regulation (see section 3.3 of this Part for the background to the development of the concept of prudential regulation) of those financial services firms not supervised by the PRA, such as asset managers and independent financial advisers.

So, the FCA is an independent financial regulator. It is governed by a Board appointed by the Treasury and is accountable to Parliament through HM Treasury. It must submit an Annual Report to the Treasury and appear before a Treasury Select Committee twice a year in scrutiny of the FCA's work. The FCA must comply with other detailed requirements contained in Schedule 1ZA of FSMA regarding how it is constituted and how it operates. The FCA describes the functions of its Board as:

- managing and challenging the FCA's senior executives
- helping to hold the FCA to account
- helping set the FCA direction.

All firms and individuals seeking to deal in, sell or give advice on financial products must be registered with, and be regulated by, the FCA, which has the authority to enforce its rules through fines, imprisonment and 'naming and shaming'. It issues a detailed Handbook which we will consider later in this Chapter.

The FCA are required to consult with four independent statutory panels, three for practitioners, plus a Consumer Panel. The FCA appoints the members of the panels, but the panels are free to express independent views. The panels provide input to the FCA from different perspectives:

Financial Services Consumer Panel: monitors how far the FCA fulfils its statutory objectives in relation to consumers. It is independent and free to publish its views on the FCA's work and to commission research on consumers' views.

Practitioner Panel: provides external and independent input to the FCA from the point of view of the industry as a whole. Members are chosen as senior level representatives of each of the major regulated sectors. There is a close relationship and some overlapping of membership with the Markets Panel. In addition, the Chairman of the Smaller Businesses Practitioner Panel is also a member of the Practitioner Panel.

Smaller Business Practitioner Panel: provides the important perspective from smaller regulated firms into the FCA, who might otherwise not have a strong voice in policy making. Senior level representatives of eligible practitioners serve on this panel. Eligible practitioners are: 'practitioners representing firms of small or medium size within their sector – whether by market capitalisation, funds under management, size of balance sheet and employees etc.' The Chairman of this panel is also a member of the Practitioner Panel. This helps to coordinate the industry views, and ensure that the smaller firm perspective is considered during Practitioner Panel deliberations.

Markets Practitioner Panel: provides external and independent input to the FCA especially from the point of view of financial market participants. Members of the Panel are senior level representatives of sectors participating in financial markets, with some specific requirements for membership in the legislation. There is a close relationship and some overlapping of membership with the Practitioner Panel, to help provide a coordinated industry view.

The FCA oversees regulated activities conducted by financial intermediaries and providers. These, and exceptions to the regulatory oversight, are considered in section 4.1 below.

1.2.1 Retail Distribution Review

A key part of the FSA's consumer protection strategy was the Retail Distribution Review (RDR). RDR was conceived as long ago as 2006 when, prior to consultation with the industry, Clive Briault, managing director of retail markets for the FSA, said: "We want a sustainable retail distribution sector that is here today, here tomorrow and here into the future. We need to ask some hard-hitting questions about the structure of this market, such as will it always lead to adverse behaviour by some to the detriment of others? Is it capable of change? And does the regulatory framework really protect those it is designed to protect without stifling innovation?"

The aim of RDR was to establish a resilient, effective and attractive retail investment market that consumers could have confidence in and trust. The RDR aimed to ensure that:

- consumers are offered a transparent and fair charging system for the advice they receive
- consumers are clear about the service they receive
- consumers receive advice from highly respected professionals.

To achieve this the FSA published rules that required:

- advisory firms to explicitly disclose and separately charge clients for their services
- advisory firms to clearly describe their services as either independent or restricted
- individual advisers to adhere to consistent professional standards, including a code of ethics, delivered with the help, guidance and supervision of the accredited professional institute of which they are a member.

These changes came into effect on 31 December 2012 and apply to all advisers in the retail investment market, regardless of the type of firm (banks, product providers, independent financial advisers, wealth managers, stockbrokers, etc.) for whom they work.

In practice, RDR has now been fully incorporated into FCA rules. But the principles it introduced can be seen in much of what is required by the FCA today.

1.3 BANK OF ENGLAND, INCLUDING THE PRUDENTIAL REGULATION AUTHORITY

The Bank of England has two core purposes, to ensure monetary stability and to contribute to financial stability. In September 2016 the Bank restated these purposes as a single all-embracing mission to promote the good of the people of the United Kingdom by maintaining monetary and financial stability.

Monetary stability means stable prices and confidence in the currency. Stable prices are defined by the Government's inflation target, which the Bank seeks to meet through the decisions delegated to the Monetary Policy Committee, explaining those decisions transparently and implementing them effectively in the money markets. Setting monetary policy – i.e. deciding on the level of short-term interest rates necessary to meet the Government's inflation target – is the responsibility of the Bank and since May 1997 the Bank has had operational independence to set monetary policy by deciding the short-term level of interest rates to meet the Government's stated inflation target. One of the main tools it uses in this is the Official Bank Rate or Bank of England Base Rate which is announced monthly, though there was no change from March 2009 to August 2016. Another tool is the adjustment of the money supply.

Financial stability entails detecting and reducing threats to the financial system as a whole. This is pursued through the Bank of England's financial and other operations, including lender of last resort, oversight of key infrastructure and the surveillance and policy roles delegated to the Financial Policy Committee. Between 1997 and 2013, the Bank of England had responsibility for the stability of the financial system as a whole, while the Financial Services Authority (FSA) supervised individual banks and other financial organisations including recognised financial exchanges such as the London Stock Exchange.

In October 1997, as part of the Bank of England's development of its role in oversight of payment systems, a Memorandum of Understanding between the Bank, HM Treasury and the FSA was agreed. This formalised the allocation of responsibilities for regulation and financial stability in the UK. A little later in December 1999 the Bank was appointed as the designating authority for payment systems following the UK's implementation of the EU's Settlement Finality Directive. The Bank has made provision for the establishment of a high level Standing Committee to provide a forum in which the three organisations could develop a common position on any problems which emerged. An updated Memorandum was issued in March 2006. This division of responsibilities was redefined by the Financial Services Act 2012.

The Financial Services Act 2012 also gives the Chancellor of the Exchequer powers to direct the Bank of England if public funds are at risk and there is a serious threat to financial stability.

The Financial Services Act 2012 included two significant changes which have impacted on the role of the Bank of England in connection with financial services:

- the creation of the Prudential Regulation Authority (PRA);
- the creation of a new macro-prudential regulator, the Financial Policy Committee within the Bank of England.

The roles of these two new bodies are outlined briefly below:

The Prudential Regulation Authority (PRA)

The PRA is a subsidiary of the Bank of England and has three statutory objectives:

- to promote the safety and soundness of institutions such as banks, building societies, all credit unions, insurance companies and investment firms;
- to secure an appropriate degree of protection for policyholders;
- facilitate competition.

The PRA works alongside the Financial Conduct Authority (FCA) creating a so-called “twin peaks” regulatory structure in the UK. (There are also three “Pillars”, being approaches to supervision considered in section 3.5 of Chapter 3 of this Part.). It issues its own detailed Rulebook.

The Financial Policy Committee (FPC)

The FPC contributes to the achievement of the Bank’s financial stability objective. It is charged with a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The Committee has a secondary objective to support the economic policy of the Government. The interim FPC first met in June 2011 and has met quarterly since. It formally came into existence on 1 April 2013.

As mentioned at the start of this section, it is the Monetary Policy Committee of the Bank of England which sets interest rates and is tasked with controlling inflation. The Deputy Governor of the FPC is one of the members of the MPC.

1.4 COMPETITION & MARKETS AUTHORITY (CMA)

Historically, under the Financial Services and Markets Act 2000, the Office of Fair Trading (OFT) was given responsibility for keeping under review the rules and practices of the FSA (now the FCA), recognised investment exchanges and recognised clearing houses, while the Competition Commission (CC) was tasked with ensuring healthy competition for the benefit of UK consumers.

From 1 April 2014 the CMA, established under the Enterprise and Regulatory Reform Act 2013, took over many of the functions of the OFT and the CC.

The CMA works to promote competition for the benefit of consumers, both within and outside the UK. Their aim is to make markets work well for consumers, businesses and the economy.

Among its responsibilities in the financial services context (their remit is wider covering issues such as corporate mergers), the CMA:

- enforces consumer protection legislation to tackle practices and market conditions that make it difficult for consumers to exercise choice
- co-operates with sector regulators and encourages them to use their competition powers.

1.5 THE PENSIONS REGULATOR

The Pensions Regulator (TPR) was created by the Pensions Act 2004 and came into being on 6 April 2005. It replaced the Occupational Pensions Regulatory Authority (OPRA) which itself had been created just eight years before by the Pensions Act 1995. OPRA had replaced the Occupational Pensions Board which had provided pensions supervision functions since 1975. TPR is the regulator of workplace pension schemes.

TPR was originally set four objectives by the Pensions Act 2004, which were updated by the Pensions Act 2008. These remain:

- to protect the benefits of members of work-based pension schemes
- to promote good administration and improve understanding of work-based pension schemes
- to reduce the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund (PPF) [the work of the PPF is discussed in the next section]
- to maximise employer compliance with employer duties (including the requirement to automatically enrol eligible employees into a qualifying pension provision with a minimum contribution) and with certain employment safeguards.

In addition, following concerns about a lack of balance between the interests of the PPF and those of employers when TPR was considering the acceptability of deficit reduction plans, a further objective was included in the Pensions Act 2014. That new statutory objective, in relation to TPR's powers in respect of scheme funding, is:

- to minimise any adverse impact on the sustainable growth of sponsoring employers when exercising those functions.

TPR has stated that in order to meet these objectives it concentrates resources on schemes where it identifies the greatest risk to the security of members' benefits. Where possible, it will provide support and advice to trustees, administrators, employers and others where potential problems are identified.

The Pensions Act 2004 provides TPR with a range of powers to enable them to meet its objectives. Its stated intention is to use these powers flexibly, reasonably and appropriately, with the aim of putting things right and keeping schemes on the right track for the long term.

1.5.1 The Powers of TPR

TPR's powers, defined in statute, are described on its website as falling into three broad categories:

- investigating schemes: how it gathers information to help identify and monitor risks;
- putting things right: what it can do where problems have been identified; and
- acting against avoidance: how it will ensure that employers do not sidestep their pension obligations.

These powers are explained in more detail below:

Investigating schemes

TPR collects data through an annual 'scheme return'. It also expects to receive reports of significant breaches of the law from 'whistleblowers', and reports of notifiable events from trustees and employers.

Trustees or scheme managers are also responsible for notifying it promptly of changes to 'registerable' information such as the scheme's address, details of trustees, or the types of benefit provided by the scheme. It also expects to receive reports where a scheme is unable to comply fully with the scheme funding framework.

In addition, it is able to demand relevant documents (or other information) from trustees and employers, among others.

Putting things right

Where TPR decides that action must be taken to protect the security of members' benefits, it has a range of options available. The action taken will depend on the circumstances of the problem. These are some examples of the regulatory action:

- issue an 'improvement notice' to individuals or companies, or a 'third party notice', requiring specific action to be taken within a certain time;

- take action, on behalf of a scheme, to recover unpaid contributions from the employer if the due date for payment has passed;
- where a wind-up is pending and members' interests may be at risk, it can issue a 'freezing order'; this order temporarily halts all activity within the scheme, so that it can investigate concerns and encourage negotiations;
- prohibit a person from acting as a trustee in relation to any scheme, a particular scheme or a particular category of schemes, if it is satisfied that the person is not "a fit and proper person" to be a trustee of a scheme, or of the schemes to which the order relates. The issuing of a prohibition order against a person has the effect of removing that person as a trustee of that scheme. When such action is taken, the name of the prohibited individual or (trustee) company is published (see TPR website). It is also possible for TPR to suspend an individual from acting as a trustee. A suspension order might be issued where TPR is awaiting the outcome of proceedings against a trustee for an offence involving dishonesty or deception or where there is a petition before the courts for an order adjudging the trustee bankrupt and the proceedings on the petition have not been concluded;
- fine individual trustees up to £5,000 and a company up to £50,000;
- prosecution of certain offences in the criminal courts;
- inspect premises and documents as necessary. If a person refuses to assist or attempts to alter, suppress, conceal or destroy any document which they are likely to be asked to produce, they are guilty of a criminal offence and are liable on summary conviction to a fine and on conviction to a fine or imprisonment (for up to two years) or both. A caution is a further sanction which can be applied in less serious instances;
- appoint a trustee to a scheme if that is deemed necessary to ensure the proper running of the scheme.

Acting against avoidance

There is a duty on trustees or managers of occupational or personal pension schemes, administrators, employers and professional advisers to report, in writing, any breaches of the law in relation to a pension arrangement to TPR.

TPR has powers to act where it believes that an employer is deliberately attempting to avoid their pension obligations, leaving the PPF to pick up their pension liabilities. To protect the benefits of scheme members and to reduce the PPF's exposure to claims for compensation, TPR may issue any of the following:

- 'Contribution notices' – where there is a deliberate attempt to avoid a statutory debt, these allow it to direct that those involved must pay an amount up to the full statutory debt either to the scheme or to the Board of the PPF.
- 'Financial support directions' – these require financial support to be put in place for an underfunded scheme where it concludes that the sponsoring employer is either a service company or is insufficiently resourced.
- 'Restoration orders' – if a transaction involving the scheme's assets has been undervalued (for example assets sold to some connected party at a price that is less than what would be expected from a genuinely arm's length transaction), these allow it to take action to have the assets (or their equivalent value) restored to the scheme.

A 'clearance procedure' is available for anyone who wishes to confirm that they will not be subject to either a contribution notice or a financial support direction following a proposed transaction. By obtaining advance clearance from TPR, the company receives assurance that that it can go ahead with the transaction without the risk that TPR will at some later stage use one of the anti-avoidance powers described above in relation to that transaction.

1.5.2 TPR and Scheme Governance

TPR regards pension scheme governance as highly important. In its 2009 statement to trustees, 'Good governance – keeping pensions safe', TPR stated:

“Good governance matters because pension scheme members entrust their savings into the hands of others. And it matters because UK occupational pension schemes hold more than an estimated £1 trillion in assets.”

TPR guidance identifies the following areas of governance and administration which Trustees need to focus on to ensure their defined benefit pension scheme is well run.

- *Scheme governance and controls*: establish and operate internal controls that enable Trustees to identify, evaluate and manage the risks that relate to their defined benefit pension scheme.
- *Record-keeping*: ensure good record-keeping and to have internal controls. This will help to ensure that data is up to date, complete and accurate.
- *Contributions*: as part of the valuation process for defined benefit pension schemes, Trustees need to work with the employer to set the contribution rate. They must prepare and maintain a schedule of contributions and check that the employer makes the correct payments.
- *Providing information to members*: Trustees must make certain information available to members, prospective members and other people entitled to benefits under their defined benefit pension scheme.
- *Working with advisers*: Trustees must ensure they have the right people to help them run and make appropriate decisions about their defined benefit pension scheme.
- *Conflicts of interest*: Trustees must identify, monitor and manage any conflicts of interest with those involved in running their defined benefit pension scheme.

TPR has issued a Code of Practice which reflects the above principles where relevant for trust-based money purchase schemes (Code of Practice 13 published July 2016) and further guidance or codes of practice covering many of these areas specifically.

TPR also expresses its aim of providing educational support for trustees, with a view to raising standards in governance. It also undertakes an annual governance survey to monitor progress in this area.

1.5.3 Financing TPR

TPR is funded by a general levy which is payable by most registered schemes: occupational schemes with only one member and schemes without a current sponsoring employer, e.g. where the sponsoring employer is in Receivership, are exempt. See below for the definition of a registrable scheme (it is NOT identical to a registered scheme which has a different meaning for tax purposes). The levy is paid at two rates, one for occupational pension schemes and one for personal pensions. In each case the levy depends on the number of members in the pension arrangement at the preceding year end. The following tables (extracts) indicate the range of the amounts involved:

2018 Levy Occupational schemes

| Number of members | General levy | Minimum payment per scheme |
|-------------------|--------------------------|----------------------------|
| 2-11 | Not relevant - flat rate | £29 |
| 100-999 | £2.08 per member | £290 |
| 500,000 and over | £0.65 per member | £430,000 |

Personal / stakeholder / group personal pension schemes

| Number of members | General levy | Minimum payment per scheme |
|-------------------|--------------------------|----------------------------|
| 2-11 | Not relevant - flat rate | £12 |
| 100-999 | ££0.81 per member | £120 |
| 500,000 and over | £0.26 per member | £175,000 |

The Levy covers the cost of running:

- The Pensions Regulator
- The Pensions Ombudsman Service
- The Pensions Advisory Service.

The general Levy is separate from the Pension Protection Fund Levy (see below). The Fraud Compensation Levy is also payable by both occupational and personal pension schemes to provide compensation where loss attributable to offences involving dishonesty arises where employers become insolvent.

1.5.4 Register of Pension Schemes

The Pensions Act 2004 requires TPR to compile and maintain a register of occupational and personal pension schemes. The register holds “registrable information” in relation to “registrable schemes” as defined in the Register of Occupational and Personal Pension Schemes Regulations 2005 (SI 2005 No 597). A registrable scheme is defined as an occupational pension scheme or a personal pension arrangement which has more than one member and is, or has been, a registered pension scheme or, prior to 6 April 2006, an approved pension scheme. Public sector schemes are also registrable. Schemes which provide only death in service benefits are not registrable (though they will usually be registered for tax purposes).

The trustees or managers of each scheme must register the scheme. The Register records all the details of the scheme and these are regularly updated. Using the Register, the DWP provides an information service known as the Pension Tracing Service. Those members who have lost contact with a particular scheme can apply to see if the Pension Tracing Service can help them re-establish contact with the scheme. The rationale for the general Levy (see table above) arose out of the need for the funding of a centralised body to act as a repository for old schemes’ data so members could find out about any entitlement to old preserved pension rights. The Pensions Tracing Service had been a function, dating back to 1990, of the old Occupational Pensions Board.

1.5.5 Memorandum of Understanding

From time to time there are suggestions that there ought to be a single regulator to deliver more effective supervision of financial services (and indeed the history of financial services regulation gives plenty of evidence of “unification” of regulation occurring). A report (principally considering auto-enrolment aspects) published in April 2013, Select Committee Report – Improving governance and best practice in workplace pensions, noted inherent weaknesses in joint working between the two regulators. While a single regulator is not likely in the foreseeable future, the FSA/FCA and TPR have endeavoured to work together.

In April 2005, the FSA and TPR issued their Memorandum of Understanding, which was updated in October 2007 and was further updated in April 2013 between the FCA and TPR. The Memorandum is designed “to assist co-operation between the FCA and TPR by setting out:

- (i) the respective regulatory responsibilities of the FCA and the Regulator, and
- (ii) arrangements for co-operation and the exchange of information”.

The aim of the Memorandum is to ensure that those involved in pensions are aware which regulator is responsible for different aspects of pensions regulation and that the application of each regulator's governing legislation is, where possible, "complementary and transparent". Areas affected by this are:

- public awareness and understanding
- consumer protection
- supervision and enforcement
- complaints and redress
- compensation arrangements
- other areas of mutual interest, including European developments relating to pensions.

The Memorandum also allows for the FCA and TPR to exchange information as appropriate in connection with carrying out their respective responsibilities for regulating pension schemes. In particular, information will be exchanged, on request, where an application has been made to the FCA for authorisation or to TPR for registration, where EEA insurance organisations provide, or apply to provide, occupational pension schemes where the UK is the host/home state, and where enforcement action is under consideration or being taken against pension scheme operators, employers, managers or trustees. The Memorandum commits the senior executives of the FCA and TPR to regular engagement including meeting at least annually.

Because of the trend for employers to offer pensions via contract-based schemes, this means more workplace pensions now fall within the regulatory remit of both TPR and the FCA. Where significant risk is identified in a scheme the regulators liaise to determine which of them should take the lead regarding the action which needs to be taken.

1.6 THE PENSION PROTECTION FUND (AND FINANCIAL ASSISTANCE SCHEME)

1.6.1 Eligibility

The Pension Protection Fund (PPF) came into effect from 6 April 2005. It applies to defined benefit and hybrid schemes (defined contribution schemes are not eligible).

Where a qualifying insolvency event occurs on or after 6 April 2005 (essentially either receivership or insolvency of the sponsoring employer) and the assets of the scheme are not sufficient to fully buy out the benefits otherwise payable by the PPF with an insurance company, then the scheme will go into the PPF. Otherwise, the scheme will have to be wound up, unless it is allowed to run as a closed scheme. Schemes which started winding up before 6 April 2005 are not covered.

1.6.2 Compensation

Once the PPF takes responsibility for a scheme, its assets and liabilities will be transferred to the PPF, which will provide compensation broadly at 100% of accrued benefits for those over Normal Pension Age (NPA) or those in receipt of an ill health or survivor's pension. For others, the compensation will be 90% of accrued benefits and will be subject to an overall cap, which depends on the member's age at the date of commencement of benefits. The cap at age 65 is, from 1 April 2018, £39,006.18 (this equates to £35,105.56 when the 90% level is applied) per year: actuarially-calculated factors are available for a derived cap at other ages. The earlier/later the date at which retirement takes place, the lower/higher the annual cap is set; this compensates for the longer/shorter time the member will be receiving payments. There is also LPI indexation, capped at 2.5%, on compensation attributable to benefits earned through service after 5 April 1997, and a 50% cap on spouse's benefit on death. From 6 April 2017, the Long Service Cap came into effect for members who have more than 21 years' service. For these members the cap is increased by 3% for each full year of pensionable service up to a maximum of double the standard cap.

In September 2018, The European Court of Justice (ECJ) ruled in the case of Grenville Hampshire v the Board of the Pension Protection Fund. This required the PPF to pay compensation at a level which is at least 50% of the accrued level. This effectively disappplies the cap.

1.6.3 Hybrid Schemes

For hybrid schemes, the Pension Protection Fund regulations set out the procedure for discharging money purchase benefits within schemes that are eligible for the PPF.

1.6.4 The PPF Levy

The main funding of the PPF comes from levies collected annually on eligible schemes. TPR collects the PPF Levy on behalf of the PPF. The PPF Levy is principally based on membership. Risk based and scheme based elements are additional amounts calculated and collected separately. The risk-based element is capped to protect vulnerable schemes. The scheme based element considers the amount of the liabilities for providing PPF benefits to the scheme members and the risk based element broadly takes account of the funding level of the scheme and the risk of employer insolvency and employer guarantees.

1.6.5 Financial Assistance Scheme

The Financial Assistance Scheme (FAS) was also set up under provisions made in the Pensions Act 2004. The purpose of the FAS was to assist members of schemes which did not qualify for the PPF who have lost pension rights because their pension scheme wound up without sufficient funds to meet the pension liabilities.

The scheme was managed by the Department for Work and Pensions and administered by the FAS Operational Unit. Responsibility has now been passed to the Board of the PPF. FAS was closed for the purposes of notification and qualification of new schemes on 1 September 2016. Members currently receiving, or with a deferred entitlement to receive, assistance payments from FAS are not affected by this change. It was originally set to close in 2006, but was kept open for a further ten years to ensure that any remaining eligible schemes had had an opportunity to come forward.

To be eligible for the Financial Assistance Scheme the scheme must in most cases have had to have started to wind up between 1 January 1997 and 5 April 2005.

Members are eligible for assistance as are a member's surviving spouse or civil partner who died after the scheme started to wind up.

The compensation now given by the FAS has been improved from that awarded when it was first established. It is now similar to the compensation provided by the PPF. Eligible members' pensions will receive 90 per cent of their accrued pension subject to a cap. This will be normally be payable from normal retirement age. A member can apply for payment earlier on the grounds of ill health but only up to five years before his normal retirement age, and the compensation would be reduced for early payment. Any compensation accrued in respect of scheme service after 6 April 1997 will be increased each year by CPI (capped at 2.5% p.a.).

1.7 INFORMATION COMMISSIONER

The Information Commissioner's Office (ICO) is the UK's independent authority set up to uphold information rights in the public interest, promoting openness by public bodies and data privacy for individuals. It enforces the Data Protection Act 1998 (DPA), the Freedom of Information Act 2000 (FoIA), the Privacy and Electronic Communications Regulations (2003 and 2011) and the Environmental Information Regulations (2004). It maintains the public register of data controllers under the DPA and approves publication schemes adopted by public authorities under the FoIA.

The ICO carries out assessments as to whether the processing of personal data is likely to be in compliance with the DPA. Where the ICO is satisfied that any of the data protection principles have been breached, an enforcement notice can be served, requiring that an organisation takes specific steps to ensure compliance. Also, it can and does levy fines.

1.8 THE PAYMENT SYSTEMS REGULATOR

The Payment Systems Regulator (PSR) is the regulator for the £81 trillion payment systems industry in the UK (Source : <https://www.psr.org.uk/about-psr/psr-purpose> April 2015): it became fully operational on 1 April 2015.

The PSR, subsequent to an earlier EU Directive itself prompted by the financial crisis in 2008, started life under the auspices of the FCA.

The PSR was formally created in the Financial Services (Banking Reform) Act 2013 and in the run up to its launch on 1 April 2015 there were extensive consultations with all those who had an interest in the payment systems industry. It continues to share FCA staff and resources. The Payment Systems Regulator says that this consultation “has informed our policy-making and helped develop our regulatory framework.”

The PSR Purpose (<https://www.psr.org.uk/about-psr/psr-purpose>) states:

“Our objectives

Our statutory objectives underpin everything we do. In summary these are:

- to ensure that payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them
- to promote effective competition in the markets for payment systems and services - between operators, PSPs and infrastructure providers
- to promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems

Our vision

- Payment systems are accessible, reliable, secure and value for money.”

1.9 COMPLAINTS PROCEDURES

Individuals today are far more aware of their rights than people were, say, in the 1970s. If things go wrong with a product or service today there is probably an “ombudsman” who can help out with a complaint. Forty years ago, a remedy could have been to sue but a lawyer was financially out of reach for most people. Furthermore the Law Society did not allow their members to advertise their services until 1986 and “no win, no fee” is a modern concept, not introduced until the 1990 Courts and Legal Services Act. However, just over forty years ago, changes were in the offing: the Fair Trading Act had set up the Office of Fair Trading in 1973.

Now, legislation has introduced regulators to oversee pension schemes and financial transactions, increased the powers of existing bodies and set up the PPF. All these have been considered in the above sections. If it is felt by any consumer that the service they have received falls short of standards set then that consumer has been empowered to take matters further, often without any legal costs. The first step is for the consumer to take up matters with the service supplier and recent legislation has obliged financial service providers to incorporate complaint procedures. The Redress section of the FCA Handbook (which we consider later in this study manual) sets out the rules. And if the client has “cold feet” then Cancellation Rights (also covered later in this study manual) are available. Today, if a client wishes to make a complaint, there are now established procedures. The complaint should be made to the firm which provided the relevant investment or service in the first instance. Where an intermediary has been used the complaint should be made to the intermediary rather than the provider.

The FCA's complaint handling rules, which take account of the MiFID business requirements, require every firm to have and to publicise an appropriate written complaints handling procedure. This should deal with complaints from eligible complainants, or a person authorised to represent them, about its provision of a financial services activity.

An eligible complainant is:

- a consumer
- a micro-enterprise (small business) which employs fewer than 10 people and has a turnover or annual balance sheet that does not exceed 2 million euros
- a charity which has an annual income of less than £1 million
- a trustee of a trust which has a net asset value of less than £1 million.

A complaint for this purpose is any expression of dissatisfaction, whether oral or written, which alleges that the complainant suffered financial loss, material distress or material inconvenience.

Firms should make customers aware of their complaints procedure at the point of sale. They must publish the appropriate information regarding their internal procedures for the resolution of complaints and supply a copy on request and to complainants when acknowledging a complaint.

The FCA rules require that once a complaint has been received a firm must investigate it "competently, diligently and impartially", obtaining additional information as necessary. It should assess "fairly, consistently and promptly" the subject matter of the complaint, whether it should be upheld and what remedial action or redress (or both) may be appropriate.

Where the firm has reasonable grounds to be satisfied that another firm may be solely or jointly responsible for the complaint, it may forward the complaint, or the relevant part of it, in writing to the other firm provided it does so promptly and informs the complainant of the reasons for this action in writing, including the contact details of the other firm. Where the original firm is jointly responsible it must deal with the part of the complaint which has not been forwarded.

Once a firm has received a complaint, it must send the complainant a prompt written acknowledgement providing early reassurance that it has received the complaint and is dealing with it. The firm must also ensure that the complainant is kept informed of the progress and of the measures being taken to resolve the complaint. There must be a final response or a further written response explaining why the firm is not yet in a position to make a final response, indicating when a final response might be expected.

When the complainant is sent this final response or a written holding response he or she must be notified of his or her right to refer the matter to the Financial Ombudsman Service (FOS) within six months. If the complaint is upheld, the firm must make an offer of appropriate compensation or remedial action. If the complainant accepts this, it should be an end of the matter. If the complainant thinks the offer is insufficient they can refer it to the FOS.

A firm must keep records of each complaint received and the measures taken to resolve it. These must be kept for five years from the date received where the complaint refers to the MiFID business and three years for all other complaints. Twice a year a firm must provide the FCA with a complete report concerning complaints received from eligible complainants.

Where a complaint is resolved by a firm by the close of business on the business day following its receipt rules concerning time limits, reporting, forwarding, and data publication do not apply. The complaints record rules do not apply provided the complaint does not relate to MiFID business.

If the Complaint per se does not resolve matters to the consumer's satisfaction, then the Complaint may be escalated to statutory bodies. We consider these further steps in the following sections.

However, Complaints will not necessarily be upheld and the client should bear that in mind. Dissatisfaction with investment performance is often not upheld as a valid Complaint. While a Complaint probably would be upheld if a cautious client were placed significantly into volatile investments, an experienced adventurous client will probably have to accept that significant equity falls can and do happen and if he has invested at the wrong time then short-term investment losses are part of the journey.

1.10 THE PENSIONS ADVISORY SERVICE AND THE PENSIONS OMBUDSMAN

While TPR is responsible for overseeing workplace pensions, the Pensions Advisory Service (TPAS) and the Pensions Ombudsman play different roles: assisting clients in the resolution of problems, complaints and disputes concerning pension plans and assisting the public generally in providing information. In this section we explain what they do.

In the resolution of complaints, TPAS gets involved before the Pensions Ombudsman (who is normally the final arbiter in the matter). TPAS does not have statutory powers and can only effect a resolution through persuasion and conciliation. The Ombudsman on the other hand has similar powers to a court of law.

1.10.1 The Pensions Advisory Service

TPAS is an independent voluntary organisation that is grant-aided by the Department for Work and Pensions. TPAS provides information and guidance to members of the public, covering state, company, personal and Stakeholder schemes. They also help any member of the public who has a problem, complaint or dispute with their occupational or private pension arrangement.

The service is free to members of the public and is provided by a nationwide network of volunteer advisers who are supported and augmented by a technical and administrative staff based in London.

TPAS also operates a national telephone helpline and also provides telephone appointments with Pension Wise guidance specialists (considered further later in this Chapter).

Occupational schemes are required to have an Internal Dispute Resolution Procedure (IDRP) which may settle the complaint. If it does not, the complainant can go to TPAS. However TPAS will not consider a case unless the complainant has already attempted to resolve it in writing with the parties involved (typically the trustees) even if the full IDRP has not been completed. They will then require copies of the correspondence and any other relevant documents. The case file will then normally be sent to one of their advisers who will try to resolve the problem if they believe that the complaint is justified. If they cannot resolve the problem, they will advise the member of what their next steps should be, which might be to contact the Pensions Ombudsman.

It was announced in the March 2016 Budget that TPAS, together with Pensions Wise and the Money Advice Service would be replaced by two new advice bodies, one dealing with pensions matters and the other with wider money issues.

1.10.2 The Pensions Ombudsman

The Pensions Ombudsman, grant-aided by the Department for Work and Pensions and which grant is largely recovered from the general Levy collected by TPR, investigates and decides complaints and disputes about the way that pension schemes are run. The Pensions Ombudsman will not normally look at a case unless it has previously been looked at by TPAS, and the Pensions Ombudsman cannot generally consider a complaint against the Trustees until the IDRP has been exhausted.

The Pensions Ombudsman's role and powers have been decided by Parliament, and he is appointed by the Secretary of State for Work and Pensions. He is completely independent and acts as an impartial adjudicator.

There is no charge on the consumer for using the Pensions Ombudsman's services, being funded by levies on financial advisers and providers.

The Pensions Ombudsman's decision is final and binding on all the parties to the complaint or dispute. It can be enforced in the Courts. His decision can only be changed by appealing to the appropriate court on a point of law.

People, and bodies such as trustees and employers, can ask the Pensions Ombudsman to decide complaints and disputes relating to the running of pension schemes. Points to note are:

- **complaints** must be that the party complained against has behaved in a way which constitutes maladministration and that the maladministration has caused injustice; (there is an exception for trustees, managers and employers – they do not have to allege injustice);
- **disputes** can be disagreements concerning fact or law; they often arise incidentally to complaints of maladministration and do not usually need a separate investigation;
- **maladministration** has been said to involve “bias, neglect, inattention, delay, incompetence, ineptitude, perversity, turpitude, arbitrariness and so on”; it is not enough merely to disagree with a decision: the complainant must have reason to believe that the decision was not properly made or implemented;
- **injustice** does not only mean financial loss – it may include such things as distress, delay or inconvenience.

There is also a Pensions Protection Fund Ombudsman (PPFO) (currently the same person as the Pensions Ombudsman – the PPFO also work from the same office as the Pensions Ombudsman and the two bodies issue joint annual accounts) who can review decisions made or consider complaints of maladministration in relation to the Pension Protection Fund (PPF). Points to note are:

- the PPF's two stage internal procedure must be completed; help to do this is available from TPAS;
- the final decision will be made by the PPF Reconsideration Committee;
- for complaints of maladministration, the PPFO may (in some circumstances) be able to review a problem before it has been through the second stage of the PPF process;
- The PPFO can accept applications from anyone who has had a decision made by the PPF Reconsideration Committee.

1.11 FINANCIAL OMBUDSMAN SERVICE

We considered in the last section the roles of TPAS and Pensions Ombudsman with regard to pensions complaints. Non-pensions problems can be referred by clients to the Financial Ombudsman Service (FOS). FOS replaced a number of previous ombudsmen, including the:

- Insurance Ombudsman
- Banking Ombudsman
- Building Society Ombudsman
- Investment Ombudsman, and
- PIA Ombudsman.

FOS was set up under s225 of the FSMA to handle disputes between consumers and financial firms, and its aim is to put consumers in the position they would have been in if things had not gone wrong.

Before a complaint is referred to the FOS, it should be raised by the eligible complainant with the financial firm in question first to give the firm a chance to put things right at an early stage.

Where a complainant is not satisfied with the firm's final decision and decides to complain to the FOS, the complainant must make the complaint within six months of receiving the firm's final decision letter. Also, if the complainant has not received a final decision from the firm within eight weeks of making the initial complaint, and does not want to give the firm any more time, he/she can then contact the FOS for a complaints form.

Also, the FOS cannot consider a complaint if it is received more than six years after the event complained of, or (if later) three years from the date on which the complainant became aware (or ought reasonably to have become aware) that he or she had cause for complaint. The FOS can consider complaints outside these limits in exceptional circumstances.

The complaints form gives the FOS the complainant's personal details, information about the complaint and details of what the complainant would like the firm to do to put matters right. This form should be returned to the FOS together with any relevant documents, including any letter from the firm setting out its final decision.

Once an application has been received by the FOS, it decides whether the complaint comes under its jurisdiction. If it does, the FOS will review the papers to see if the complaint can be resolved informally through mediation or conciliation. The FOS will not usually handle a case which has already been considered by a court, or where court proceedings are pending.

Where it is not possible for a complaint to be resolved informally, a formal investigation will take place which will ultimately conclude in an FOS's decision. This decision is binding on the firm, but not on the complainant, unless he or she accepts the decision. If the complainant does not accept the FOS's decision he or she is free to take the matter to the courts. If the claimant does not respond to the FOS's decision letter it is treated as a rejection and the firm is not bound by the decision.

The FOS can award monetary compensation for:

- financial loss, e.g. direct compensation for loss of money, and
- non-financial loss to compensate for suffering, damage to reputation, distress or inconvenience.

Awards can be up to a maximum value of £150,000 plus the complainant's costs and interest for complaints received after 1 January 2012 (prior to this date the maximum value was £100,000). The FOS can recommend a higher award, but this would not be binding on the firm. The FOS can also order the firm to take remedial action.

The FOS's jurisdiction is compulsory for authorised firms in the UK and covers all regulated activities, unsecured lending, card payments, consumer credit activities, and banking services.

The FOS has a Memorandum of Understanding with the Pensions Ombudsman for personal pensions and small occupational pension schemes. Under this memorandum, the FOS will deal with complaints concerning the sale of an arrangement while the Pensions Ombudsman will deal with any problems relating to the management or administration of the pension arrangement.

The FOS is funded by a general levy paid by businesses regulated by the FCA. The amount of levy that each individual business has to pay can range from around £100 a year for a small firm of financial advisers to over £300,000 for a high-street bank or major insurance company. In addition, a £550 case fee is charged for complaints made against individual firms. Businesses are entitled to 25 "free" cases each financial year, but will be charged the flat-rate fee for the 26th and any subsequent chargeable cases in the year.

1.12 FINANCIAL SERVICES COMPENSATION SCHEME (FSCS)

The FSCS was set up under the FSMA and became operational on 1 December 2001. It was established as the UK's compensation fund of last resort for customers of financial services firms, i.e. it pays compensation if a firm is unable, or likely to be unable, to pay claims against it. This is usually because it has stopped trading or has been declared in default. The FSCS replaced the Policyholders' Protection Scheme, the Investors Compensation Scheme and the Deposit Protection Scheme.

The FSCS is funded by levies on firms authorised by the PRA and the FCA. The levies are decided each year by allocating expected costs between providers and intermediaries, further split between General Insurance, Life and Pensions, Investment, Home Service and Deposit businesses. The FSCS's costs are made up of management expenses and compensation payments: compensation payments make up the majority of the costs.

The FSCS covers business conducted by authorised firms. European firms (authorised by their home state regulator) that operate in the UK may also be covered. Any claim must be made by an eligible claimant and relate to:

- deposits
- insurance policies
- insurance broking (for business on or after 14 January 2005), including connected travel insurance where the policy is sold alongside a holiday or other related travel (e.g. by travel firms and holiday providers) (for business on or after 1 January 2009)
- investment business
- home finance (for business on or after 31 October 2004).

There are limits on the amounts of compensation the FSCS can pay, and the actual level of compensation will depend on the basis of your claim. The FSCS only pays compensation for financial loss. Compensation limits are per person per firm, and per claim category.

The maximum levels of compensation are:

- **Deposits:** 100% of £75,000 per person per firm (for claims against firms declared in default from 31 December 2010). Prior to 1 January 2016, the maximum was £85,000 but this was reduced to £75,000 on 1 January 2016 reflecting Sterling's strength against the Euro. Because of the weakness of Sterling following the Brexit referendum result, the maximum is to be increased back to £85,000 on 31 January 2017. The European Union Deposit Guarantee Schemes Directive fixes a harmonised limit of ?100,000 (or the equivalent) across Europe.
- **Large Temporary Deposits:** from 3 July 2015 a temporary (up to six months) protection of up to £1,000,000 is being provided by the FSCS; this is intended to cover cash amounts arising from house sale/purchase and estates on death.
- **Investments:** 100% of the first £50,000 per person per firm (for claims against firms declared in default from 1 January 2010)
- **Home Finance (e.g. mortgage advice and arranging):** 100% of the first £50,000 per person per firm (for claims against firms declared in default from 1 January 2010)
- **Insurance Business:** 90% of the claim with no upper limit. Compulsory insurance is protected in full
- **General insurance advice and arranging:** 90% of the claim with no upper limit (for business conducted on or after 14 January 2005). Compulsory insurance is protected in full.

The FSCS does not cover the Channel Islands or the Isle of Man.

Eligible claimant

Briefly an eligible claimant is any natural person. Firms and companies are generally excluded from claiming: the FCA Handbook at COMP 4.2.2 lists the exclusions:

1.13 PENSION WISE

The Government invited responses (the consultation period ran until June 2014) re its wish to create a new “Guidance Guarantee” for people retiring with defined contribution pensions. The Treasury required this service:

- to be impartial and of consistently good quality;
- to cover the individual’s range of options to help them make sound decisions and equip them to take action, whether that is seeking further advice or purchasing a products free to the consumer;
- be offered face to face.

The initial concept behind the Guidance Guarantee service was to provide assistance to members coming up to retirement as to the nature of the annuity they needed.

On 6 April 2015, therefore, significant changes came into effect providing members of defined contribution pension schemes greater freedom to access their retirement savings. Individuals are entitled to free, impartial guidance on their choices about how to use their retirement savings at retirement (called the ‘Guidance Guarantee’). This service is provided by Pension Wise. On their Website they state: Pension Wise is a free and impartial service that helps you understand your new pension options. You can get help on the Pension Wise website, over the phone or face to face about:

- the different ways you can take money from your pension pot
- what each option means for your circumstances
- next steps you can take.

Pension providers and trustees to schemes are expected to signpost people to the Pension Wise service as they approach retirement. Initially the Treasury had overall responsibility for the service design. Initially, telephone and online guidance was given by the Pensions Advisory Service and face-to-face guidance by the Citizens’ Advice Bureau (Guidance Guarantee Delivery Partners). The Pension Wise service was subsequently transferred to the Money and Pensions Service (MaPS) (see 1.14).

The Financial Conduct Authority (FCA) is responsible for setting the standards for the Guidance Guarantee Delivery Partners and has issued standards and rules for delivery in Policy Statement 14/17 (updated in February 2015 with retirement risk warnings).

After an appointment individuals receive a letter with a summary of the pension options and what they mean for their personal circumstances. Pension Wise guidance specialists do not recommend any products or companies and do not provide investment advice.

Pensions Freedoms extended the scope of issues on which Guidance may be sought.

1.14 THE MONEY AND PENSIONS SERVICE (MaPS)

The Money and Pensions Service (MaPS) was created on 1 January 2019 following the merger of the Money Advice Service (MAS) and The Pensions Advisory Service (TPAS). Sponsored by the Department for Work & Pensions (DWP), it is an arm's-length body committed to ensuring that people throughout the UK have guidance and access to the information they need to make effective financial decisions over their lifetime. It is funded by levies paid by pension schemes and the wider financial services industry.

MaPS has five key functions:

- * MaPS provides pension guidance to the general public about workplace and personal pensions. Additionally, MaPS also supports those aged over 50 to make decisions on their Defined Contribution pension savings through the Pension Wise service.
- * MaPS provides people in England with information and advice about debt management.
- * MaPS provides information to help the public develop a better understanding of how to manage day-to-day finances
- * MaPS works closely with the Financial Conduct Authority (FCA) to protect consumers against scams
- * MaPS plays a strategic role in educating children and young people about financial wellbeing. It has published the UK Strategy for Financial Wellbeing with the goal of driving significant, coordinated change over the longer term, building on the work of the Financial Capability Strategy for the UK.

Summary

In this Chapter we have considered the regulation of the financial regime and the bodies associated with it, looking in particular at the role of the Financial Conduct Authority

We have looked at the legislative background to regulating financial services and at the roles of other bodies (and the internal Complaints function) charged with regulating financial services including:

- HM Treasury
- Financial Conduct Authority (FCA)
- Bank of England including the Prudential Regulation Authority (PRA)
- Competition and Markets Authority
- The Pensions Regulator
- Pension Protection Fund (and Financial Assistance Scheme)
- Information Commissioner
- Payment Systems Regulator
- Complaints Procedure
- Pensions Advisory Service and the Pensions Ombudsman
- Financial Ombudsman Service
- Financial Services Compensation Scheme
- Pension Wise
- Money Advice Service.

Self Test Questions

- What did the FSMA do?
- What are the FCA's four statutory objectives?
- Describe the Bank of England's two core purposes.
- What were TPR's four objectives, prior to May 2014? And what new objective was it given?
- Which body has now taken over the functions of OFT?
- Define an eligible complainant under the FCA's complaint handling rules.
- Outline when and how a firm describes its Complaints procedure.
- What are the differences between TPAS and POS?
- Describe the role of the Financial Ombudsman Service.
- Describe the role of the Financial Services Compensation Scheme.
- What is the difference between Pensions Wise and MAS?

CHAPTER 2

Key Uk Legislation and Eu Directives

INTRODUCTION

As considered in the previous Chapter, the first legislation specifically regulating the UK financial services industry was introduced by the Financial Services Act 1986 and this legislation has been substantially developed in subsequent primary and secondary legislation. We consider this legislation further in this Chapter and place it into an EU context. Note that much of the financial services legislation now introduced in the UK reflects EU requirements. The Financial Services Action Plan was a set of proposals put forward in May 1999 by the European Commission, setting out its objectives of creating a single market for financial services across the EU backed by modern rules and robust supervision.

It is the underlying requirements of this legislation which give rise to the substantial oversight of advisory firms by the FCA (and other bodies) and in turn the responsibilities imposed on those individuals wishing to offer financial advice in the UK. We consider these aspects in detail later in this Part.

The 23 June 2016 Referendum which has precipitated Brexit will undoubtedly have an effect on the direct link between EU Directives and UK law. But in practice the time taken to finalise the UK's withdrawal from the EU, the fact that legislation is already on the UK's Statute books and the expected ongoing links between the UK and the EU will mean that few changes will arise. Arguably, much of the EU consumer protection legislation which underpins UK financial regulation would have been enacted in any event. Not only has the UK had a significant influence on EU financial services legislation (the Financial Services Act 1986 preceded the Financial Services Action Plan by well over a decade) but also bear in mind that Norway, not a member of the EU, has adopted three-quarters of EU legislation [Source: Guardian 27 October 2015, former Norwegian Foreign Minister, Espen Barth Eide]. Whatever happens in the future, EU legislation has already had a significant influence on UK laws and for the time being remains as relevant as it ever was. And nothing will prevent the UK from adopting good ideas in future from other countries, EU-led or otherwise. Consider the UK's long-standing interest in North American investment ideas and the repeated references to pensions systems in New Zealand and Australia as stakeholder and NEST pension concepts were developed in the UK.

The FCA issued a Statement on 24 June 2016 as follows:

"The FCA is in very close contact with the firms we supervise as well as the Treasury, the Bank of England and other UK authorities, and we are monitoring developments in the financial markets.

Much financial regulation currently applicable in the UK derives from EU legislation. This regulation will remain applicable until any changes are made, which will be a matter for Government and Parliament.

Firms must continue to abide by their obligations under UK law, including those derived from EU law and continue with implementation plans for legislation that is still to come into effect.

Consumers' rights and protections, including any derived from EU legislation, are unaffected by the result of the referendum and will remain unchanged unless and until the Government changes the applicable legislation.

The longer term impacts of the decision to leave the EU on the overall regulatory framework for the UK will depend, in part, on the relationship that the UK seeks with the EU in the future. We will work closely with the Government as it confirms the arrangements for the UK's future relationship with the EU."

The above “no change” stance has been reaffirmed: speaking to the House of Lords European Union justice sub-committee on 10 October 2017, the FCA's executive director of strategy and competition told firms in the financial services sector that a “bonfire of regulations” after Brexit would not be in their interests, also pointing out that many standards were now set globally.

2.1 UK LEGISLATION

The key legislation now governing the regulation of the financial services industry and its conduct of business is the Financial Services and Markets Act 2000 (FSMA). The FSMA consolidated much of the regulation of all sectors of the financial services industry, giving it a much wider scope than the Financial Services Act 1986.

Only those firms and individuals authorised by the FCA can undertake regulated activities (section 4.1 covers this aspect in more detail). These activities include dealing in, arranging deals in and managing or offering advice regarding any of the activities listed above. This also includes using a computer-based system, so-called “robo- advice”, for giving investment instructions. (In its 2016/17 Business Plan the FCA specifically commented on the greater use of technology, saying: “the limited information and the speed of action consumers experience could lead to inappropriate decision making.” Further legislation and regulation could emanate in this and indeed any other area which falls within the ambit of the FCA.) The legislation referred to in the last but one paragraph has been supplemented by the Financial Services Act 2012, the most relevant aspects of which have been covered in the previous Chapter.

Other UK Legislation

While the FSMA consolidated much of the financial services legislation at the time, other UK Statutes also have bearing on the conduct of financial advisers and financial advisory firms.

Section 3.1 of the following Chapter considers other legislation relevant to the FCA's remit.

Oversight within firms

Complementary to the requirements of and supervision by regulatory bodies, there is additional oversight within firms over individuals carrying out regulated activities. It is principally by this additional oversight, delivered by Compliance officers, that the detailed requirements of the regulators are met. This does not, however, preclude the regulator from fining an individual, disciplining him (and noting his record on the FCA Register) or withdrawing his licence to advise.

A substantial element of the evolved legislative requirements is consolidated into Treating Customers Fairly (TCF). We consider TCF later in this Module.

2.2 EU DIRECTIVES

Background to Directive creation

A Directive is part of the legal processes of the EU. It stipulates the desired overall result, though the Government of each Member State will determine the exact form, methods and date (subject to an EU-stipulated final operational date).

The proposed wording for the Directive is prepared by the European Commission, probably in response to a policy decision made by the European Council, the latter being composed of heads of member governments (or their ministerial representatives). In practice the Commission operates in a manner similar to the British Cabinet, with one representative from each EU country. The Directive wording is developed in consultation with the Commission's own and with national experts. In this the FCA has had a past role in presenting British financial expertise to the Commission. The draft then goes before the European Parliament, initially for debate and comment, then subsequently for approval or rejection.

Directives are generally binding on all member states. When accepted, Directives provides a timetable for implementation. If this is not done (assuming that the national State does not already meet the Directive requirements) then ultimately the European Court of Justice can insist on implementation and require damages to be paid to citizens of the country who have been adversely affected by that country's failure to implement the Directive.

The EU also issue **Regulations**. These are binding across the whole of the EU and do not allow for the limited flexibility accorded by Directives.

Examples of relevant financial services Directives

In recent years (note the publication in 1999 of the Financial Services Action Plan proposals referred to in the Introduction to this Chapter), the EU has been working towards tackling differences in the financial services sectors in member states. To that end a number of EU directives have been introduced with the aim of creating a single market for EU/EEA countries (the EEA – European Economic Area – is made up of the EU member states plus Iceland, Liechtenstein and Norway). These include:

- Markets in Financial Instruments Directive (MiFID)
- Insurance Mediation Directive (IMD) which is being updated by the Insurance Distribution Directive
- Banking Directive
- Third Non-Life Insurance Directive
- Consolidated Life Assurance Directive
- UCITS Directive
- Reinsurance Directive
- Capital Requirement Directive
- Market Abuse Directive
- Third Money Laundering Directive
- Distance Marketing Directive
- Payment Services Directive
- Second Electronic Money Directive.

EU law-making is ongoing. As a further example, from 31 December 2016 a Regulation provided for a harmonised Key Information Document to be used for all sales of Packaged Retail and Insurance-based Investment Products. The FCA have taken this up in their Policy Statement 17/6 with Handbook revisions from 1 January 2018. The PRIIPs Regulation will require persons within its scope to draw up, publish and provide a KID for each PRIIP manufactured. The regulations, and related regulatory technical standards, set out the form and content of the KID. In developing and making this legislation, the European Parliament and the Council of the European Union's aim, endorsed by the FCA, is to help retail investors compare products and make informed decisions, and to facilitate the single market for PRIIPs.

"Passporting" rights arise under the EU single market directives. This means that a person whose head office is in one EEA State is entitled to carry out an activity in another EEA state provided they fulfil the conditions of the relevant directive. However, it is not necessary to fulfil UK RDR requirements if it is not relevant in the "home" State.

Following Brexit, the UK, like Switzerland, will not be a member of the EEA, unless negotiations are conducted to achieve such membership. The non-EU EEA countries (Iceland, Liechtenstein and Norway) have established themselves as part of the single EU market in return for accepting the four freedoms: free movement of capital, goods, services and people. Switzerland, though a member of EFTA (which organisation develops trade agreements), relies on bi-lateral agreements. The UK was one of the founder members of EFTA before relinquishing that membership on joining the then European Economic Community. Significant renegotiation will be needed (and that may impinge on financial services regulations) but meanwhile the existing EU regulations remain.

The Channel Islands and the Isle of Man, even though they are Crown dependencies, are outside the EEA and, therefore the EU directives do not apply in these territories. They do, however, apply to Gibraltar.

We consider in more detail below four of the above EU directives particularly relevant to UK regulated activities in financial services.

Markets in Financial Instruments Directive (MiFID)

The Markets in Financial Instruments Directive (MiFID) is the framework of European Union (EU) legislation for:

- investment intermediaries that provide services to clients around shares, bonds, units in collective investment schemes and derivatives (collectively known as 'financial instruments') and
- the organised trading of financial instruments.

MiFID came into effect on 1 November 2007, replacing the Investment Services Directive (ISD). Amendments were made to UK legislation and rules to incorporate its provisions by that date. MiFID extended the coverage of the ISD and introduced new and more extensive requirements which firms had to adopt, in particular for their conduct of business and internal organisation.

Very briefly, the aims of the ISD, adopted in 1993, were:

- to require that the regulatory authorities in each EU member state ensured that investment firms had sufficient initial financial resources for the proposed activities;
- to require that the persons directing the business had sufficient professional integrity and experience;
- to harmonise certain conditions governing the operation of regulated markets.

MiFID widened the range of "core" investment services and activities that firms can passport. In addition to the services covered by the ISD, MiFID:

- upgrades advice that involves a personal recommendation to a core investment service that can be passported on a stand-alone basis
- introduces operating a multilateral trading facility as a new core investment service covered by the passport
- extends the scope of the passport to cover commodity derivatives, credit derivatives and financial contracts for differences for the first time.

MiFID also promotes a greater degree of harmonisation, facilitates cross-border business by improving the "passport" for investment firms by drawing a clearer line between the respective responsibilities of home and host states and requires most firms that fall within the scope of MiFID also to comply with the Capital Requirements Directive which sets requirements for the regulatory capital a firm must hold.

MiFID covers services provided by:

1. an investment firm with its head office in the EEA (or, if it has a registered office, that office);
2. a credit institution;
3. a collective portfolio management investment firm.

MiFID plays a major part in the EU's Financial Services Action Plan (FSAP), which was designed in 1999 to help integrate Europe's wholesale and retail financial markets. Its aim is to create a single EU marketplace for investment services. To accomplish this, there needs to be a common set of standards. Therefore MiFID imposes certain requirements on investment managers. Notable amongst these is the adoption of a formal 'best execution' policy.

Best execution means that when firms execute client orders (i.e. buy or sell securities), they must take all reasonable steps to deliver the best possible result for their clients. Whilst the price achieved is one factor, there are other factors that may be taken into account by the manager, including:

- speed of transaction;
- reputation of the counterparty; and
- associated fees and costs.

The Directive requires investment firms to provide information to their clients in relation to the firm's policy in terms of best execution and also that they obtain the client's consent to that policy.

On the whole, MiFID has been transferred to the FCA Handbook and the FSA/FCA has used the implementation of MiFID as a catalyst for reviewing and simplifying its Handbook.

MiFID is currently being revised to improve the functioning of financial markets in light of the financial crisis and to strengthen investor protection. The changes are currently set to take effect from 3 January 2018, with the new legislation being known as MiFID II - this includes a revised MiFID and a new Markets in Financial Instruments Regulation.

Insurance Mediation Directive (IMD) and Insurance Distribution Directive (IDD)

IMD provided a set of "conduct of business" rules for the sale (at the point of sale) of insurance products, both life and general, to ensure a basic harmonised level of consumer protection throughout the EU. The subject continues to receive the attention of the European Commission and future changes and the IDD is intended to strengthen the application of the original aims.

The original Directive (2002/92) stated its aims as:

- **professionalism and competence** among insurance intermediaries
- **protection** of customers' interests
- that individuals/companies providing insurance or reinsurance mediation are **registered in their home EU country** (which allows them to do business elsewhere in the EU)
- Respect for **minimum professional requirements** such as:
 - appropriate knowledge and ability
 - good reputation
 - professional indemnity insurance or other comparable guarantee
 - sufficient financial capacity to protect customers.
- **clear explanations** for customers on the advice given
- **involvement of national financial authorities and other bodies** in the registration process
- easy public access to **details of registered insurance and reinsurance intermediaries**
- appropriate and effective **alternative dispute resolution procedures**.

It is not difficult to see that these aims are reflected in the (much more detailed) requirements of the FCA Handbook, which we will shortly be considering.

EU member states were required to implement the IMD by 14 January 2005, under which, broadly, all persons who carry on an insurance mediation activity (insurance mediation activity is defined in the FCA Handbook Glossary: briefly it means engaging in a regulated activity):

- must be authorised by a relevant competent authority
- are subject to certain obligations relating to systems and controls, regulatory capital, client assets and approved persons
- are regulated with respect to the way that they communicate with clients, issue financial promotions (including content), handle claims and advise on, sell and cancel products.

To comply with IMD, HM Treasury brought non-investment insurances – i.e. general insurance and protective insurance – into the scope of the FSA, now PRA, regulation in January 2005.

The IMD will be updated during 2018 by the Insurance Distribution Directive, probably on 1 October, the European Commission having postponed the original intended start date.

Intermediaries who give advice on or arrange insurance based products must have a minimum level of Professional Indemnity Insurance (PII). From 23 February 2018 these are set at ?1,250,000 for a single claim and in aggregate ?1,850,000 or, if higher, 10% of annual income up to £30 million. These limits are reviewed every five years to take account of movements in European consumer prices.

As part of the professionalism and knowledge standards, advisers will need to complete a minimum of 15 hours of CPD, though the FCA have stated that they will continue to expect the existing 35 minimum requirement to be met.

The new IDD regime will introduce two general principles, requiring that:

- insurance distributors “always act honestly, fairly and professionally in accordance with the best interests of customers”;
- all information provided to clients must be “fair, clear and not misleading”.

These two principles are more or less the same as in the FCA’s existing Principles for Business. Arguably the FCA are ahead of the game.

Capital Requirements Directive

By way of background, the Basel Accord (Basel I) was agreed in 1988 by the Basel Committee on Banking Supervision. The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialised countries which meets every three months at the Bank for International Settlements in Basel, Switzerland. Basel I helped to strengthen the soundness and stability of the international banking system as a result of the higher capital ratios that it required. It was implemented in the EU via the Capital Requirements Directive (CRD) and came into force on 1 January 2007.

The CRD framework was revised by Basel II. It introduced the concept of three “pillars”. Pillar 1 set the minimum capital requirements firms are required to meet for credit, market and operational risk. Under Pillar 2, firms and supervisors have to decide whether a firm should hold additional capital against risks not covered in Pillar 1. Pillar 3 requires firms to publish certain details of their risks, capital and risk management. Its gradual introduction started in early 2008 though in practice Basel II was overtaken by the events of 2008/9.

Following the crisis in financial markets in 2008 and 2009, Basel III was introduced which, mindful of the risk of a run on banks, further strengthened the regulatory regime applying to credit institutions in the following areas:

- enhancing the quality and quantity of capital
- strengthening capital requirements for counterparty credit risk resulting in higher Pillar 1 requirements
- introducing a leverage ratio (briefly a ratio of capital to assets) as a backstop to risk-based capital
- introducing two new capital buffers: a basic level of capital conservation and an additional “countercyclical” capital buffer which can be imposed at the national regulator’s discretion in periods of high credit growth
- implementing an enhanced liquidity regime through the Net Stable Funding Ratio and Liquidity Coverage Ratio.

The requirements continue to be strengthened: on 16 April 2013 the European Parliament introduced CRD IV to improve transparency, responsibility and regulation in financial institutions and to increase the requirements for and quality of financial institutions' capital through higher requirements for their core capital. On 17 July 2013 the EU incorporated this legislative package into the EU legal framework as the Basel III Accord. The new requirements introduced by Basel III started to apply from 1 January 2013, while other provisions will be gradually phased-in by January 2019.

The Solvency II Directive (2009/138/EC) is an EU Directive which primarily concerns the amount of capital reserves that EU insurance companies must hold to reduce the risk of insolvency. Subsequent to an EU Parliament vote on 11 March 2014, Solvency II, after a number of delays came into effect on 1 January 2016

Money Laundering Directives

Money Laundering is nothing new. Money Laundering was well-known early in the 20th Century when gangsters like Al Capone pitted their wits against the authorities. The successful incarceration of Capone at Alcatraz - and that was for the offence of \$1,000,000 tax evasion, very minor compared with his wider activities where he placed \$100s millions of illegally obtained monies through "legitimate" business enterprises - led to the fraudsters becoming more organised. In response, authorities across the world needed to become more organised themselves. And so it continues.

The EU is constructed around free movement of, inter alia, money and capital. In the effort to prevent this freedom being misused by criminals, the First Money Laundering Directive (91/308/EEC), effective from June 1993, required financial institutions to obtain evidence of customers' identity. In this it adopted recommendations made by the Financial Action Task Force (FATF). The FATF is an independent inter-Governmental body which was established following the 1989 G7 Summit in Paris, where it remains headquartered, to combat the growing problem of money laundering. It develops and promotes policies to protect the global financial system against money laundering and terrorist financing. Its recommendations are recognised as the global anti-money laundering (AML) and counter-terrorist financing standard. The EU translates these standards into EU law through the money laundering directives. When anti-money laundering regulations were first introduced, UK financial institutions did not need to obtain identity evidence for existing customers, just new customers.

The Second Money Laundering Directive (2001/97/EC) clarified for example which national institutions should receive reports and that money exchange bureaux and money transmitters were covered by the regulations.

The main purpose of the Third Money Laundering Directive (2005/60/EC) was to update EU legislation in line with the revised FATF recommendations. It repealed and built on earlier AML Directives against the background of fears over terrorist financing, which activity was emphasised in the Directive: earlier Directives had concentrated more on the widespread concern over drugs trafficking. The UK's Money Laundering Regulations 2007 came into effect on 15 December 2007. These regulations transpose the EU's Third Money Laundering Directive into the UK, strengthening the requirements which already applied. Obtaining and retaining evidence that a customer is who he claims to be, has become an integral part of the advice process. The requirements need to be satisfied before an adviser can provide any advice to a client.

The EU's Fourth Money Laundering Directive came into effect in the UK on 26 June 2017 replacing the Third Anti Money Laundering Directive. Enhanced diligence with regard to Politically Exposed Persons (see section 4.5 below) is required and an increased level of transparency re the beneficial ownership of both companies and trusts including the requirement for such information to be held on a public register. The UK Government had already taken the lead in the EU and introduced a requirement in the Small Business, Enterprise and Employment Act 2015 for UK companies to maintain a register of persons having significant control; this came into force on 6 April 2016 and the beneficial ownership data must be available at Companies House or from the company's registered office. Briefly "significant control" means owning or controlling, directly or indirectly 25% or more of that company's voting shares. Despite the threat of penalties on owners who fail to file information correctly, advisers will need to be aware that the Companies House information will be largely unaudited and in consequence may need to independently verify data. As indicated above, the scope of the Directive is wider than corporates: its requirements apply to trusts and other legal entities rather than just companies. Significant lobbying from trusts has meant that while they record information this will not need to be placed on the public register.

Finalisation in the EU legislative process of the requirements of the Fifth Money Laundering Directive is planned for 2018 to supplement (not replace) the extant Directive. National legislative bodies in the EU will then need to adopt. Among other provisions it is intended that identification of customers for remote payments exceeding 50 Euros will be required and issuers of pre-paid cards in countries outside the EU will have to prove that they apply equivalent customer due diligence measures to those in the EU if such pre-paid cards are to continue to be accepted

Summary

This Chapter has considered the legislative background to financial services regulation, looking particularly at the impetus given by EU directives. It is this legislation which underpins many of today's advisory processes.

Self Test Questions

- Describe the UK legislation regulating financial services and what it covers.
- What is the main purpose of the EU's Markets in Financial Instruments Directive (MiFID)?
- What was the intention of IMD?
- What is the main thrust of the Fourth Money Laundering Directive?

CHAPTER 3

The FCA's Responsibilities

INTRODUCTION

As the student will already know from the earlier Chapters in this Part, the FCA has a number of powers and responsibilities derived from the financial services legislation and regulations and which it inherited from the FSA. This Chapter looks at these aspects in detail, analyses the importance of the FCA Handbook from which day-to-day rules governing retail financial services are derived and describes the regulatory processes and risk-based supervision. This Chapter also briefly covers the role of the PRA.

3.1 FCA'S POWERS AND ACTIVITIES

The FSA was the single regulator for retail financial services in the UK between December 2001 and March 2013, when its powers were transferred to the FCA by the Financial Services Act 2012. The FSA was created by the FSMA and it is from this Act that it derived its powers and functions. These included a wide range of rule-making, investigatory and enforcement powers to enable it to meet its statutory objectives. Its rules and the guidance were contained in the FSA Handbook are made by powers derived from the FSMA.

HM Treasury has the power under the FSMA (conferred on them by sections 22(1) & (5), 426 & 428(3) and paragraph 25 of Schedule 2 of FSMA) to make secondary legislation, which affects the way the FCA (previously FSA) operates. For example, this has included the Financial Services and Markets Act (Regulated Activities) Order 2001 which sets out the specific activities for which firms must receive FCA permission or authorisation to carry out regulated activities. More recently, The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2013 transferred the regulation of consumer credit from OFT to the FCA.

The FCA and PRA are now jointly the designated competent authorities under the European single market directives for banking, insurance, investment business, payment services, collective investment schemes and other financial services, including insurance intermediation. They are also the competent authorities under a host of other EU directives, including the Market Abuse and Prospectus Directives. European legislation affecting the FCA in regulated financial services is implemented through the FSMA, other primary legislation, FCA rules and/or Treasury regulations.

The FCA, according to its 2017/18 Business Plan, is the conduct regulator for 56,000 financial services firms and financial markets in the UK and the prudential regulator for over 18,000 of those firms. They also regulate financial markets in the UK (this covers all financial industry sectors, including some consumer credit firms - not all credit firms require authorisation) and over 140,000 approved persons.

The FSA was a body corporate limited by guarantee (refer back to section 1.2 of Chapter 1 of this Part for further detail) and was subject to generally applicable company and accounting law. The FSMA gave specific responsibilities to the FSA's non-executive directors, such as reviewing the economic and efficient use of resources and setting the pay of executive board members. It also set out a number of explicit standards that the FSA should have met in carrying out its duties – for example, time periods within which it must take certain decisions. Broadly, the FCA inherited similar features.

The FCA has powers over unregulated firms and persons regarding market abuse, breaches of money laundering regulations and short selling. It also has the power to prosecute unauthorised firms or persons carrying on regulated activities.

The FCA's Annual Report and Accounts for the year ending 31 March 2016 refers to action they have taken: penalties of £884.6m imposed on firms and individuals, banning 24 individuals and seeing jail sentences totalling 32 years and nine months' imprisonment handed down to individuals they have prosecuted. The Annual Report and Accounts for the year ending 2017 identifies substantial fines imposed on Deutsche Bank and Tesco as well as action taken against individuals for insider dealing.

In addition to the powers under FSMA inherited from the FSA, the FCA has regulatory powers under the:

- Building Societies Act 1986
- Friendly Societies Acts (1974 and 1992)
- Industrial and Provident Societies Act 1965.

The following are some of the more significant functions the FCA has under non-FSMA legislation:

Enterprise Act 2002 and Enterprise and Regulatory Reform Act 2013 – The FCA is a consumer enforcer under the Enterprise Act 2002. This gives it the power to apply to the courts to stop traders infringing a wide range of consumer protection legislation where those infringements harm the collective interests of consumers. The Enterprise and Regulatory Reform Act 2013 established the CMA to replace OFT.

Proceeds of Crime Act 2002 – The FCA is an accredited financial investigator for confiscations, investigations and restraining orders.

Consumer Rights Act 2015 – (replacing the Unfair Terms in Consumer Contracts Regulations 1999) The FCA may seek an injunction to prevent the use of a contract term drawn up for general use in a financial services contract that appears to be unfair as described in the regulations.

Financial Services (Distance Marketing) Regulations 2004 – The FCA is the body responsible for considering and, if necessary, taking action against persons responsible for breaching specified contracts: in particular, regulations relating to certain financial services contracts entered into at a distance.

Money Laundering Regulations 2017 – The FCA is the supervisory authority for credit and financial institutions (firms), trust or company service providers (firms) and for various other financial institutions. This requires it to effectively monitor such persons and take whatever measures are necessary to ensure their compliance with the regulations.

Regulated Covered Bonds Regulations 2008 – The FCA is responsible for supervising the regime, including admission of issuers and bonds and reporting in relation to regulated covered bonds. It also maintains a register of the issuers of regulated covered bonds and has supervisory and enforcement powers.

Payment Services Regulations 2009 and Electronic Money Regulations 2011 – The FCA is responsible for registering and authorising payment and e-money institutions and for regulating payment service and e-money providers. (Note that the Payment Systems Regulator remains a subsidiary of the FCA.)

Financial Services (Banking Reform) Act 2013 – The FCA is responsible for senior management oversight (though currently limited largely to banks and credit institutions).

3.2 COMPETITIVE MARKETS AND FINANCIAL STABILITY

The FCA's ability to discharge its new duty and use its powers, granted under the Financial Services Act 2012 to promote effective competition, is a significant change: it improves its ability to make markets work well for consumers. An excellent example of this is the FCA's Thematic Review * of Annuities: their Press Release of 14 February 2014 started with the words "The annuities market is not working well for consumers, a review by the Financial Conduct Authority (FCA) has found. The FCA will now use its new remit to launch a Competition Market Study to get to the heart of the issue and make recommendations that will have wider implications as to how the market operates". These comments not only show that the FCA is using its powers but also the way in which they operate and deliver results.

New powers came into force on 1 April 2015 that gave the FCA the ability to enforce against infringements of competition law, additional powers to conduct market studies and powers to refer markets to the Competition and Markets Authority (CMA) for in-depth investigation with regard to financial services. The CMA can also exercise these powers.

**see section 3.5.4 for an explanation of the use of Thematic Reviews.*

Historically, the FSA had a regulatory objective of contributing to the protection and enhancement of UK financial stability. Section 250 of the Banking Act 2009 imposed a duty on the FSA to collect information that it thinks is, or may be, relevant to the stability of individual financial institutions or to one or more aspects of the UK financial system and this duty has now passed to the PRA. The FCA however continues to have a role in maintaining the UK's financial stability.

The FCA is a member for the UK (together with the Bank of England and HM Treasury) of the international Financial Stability Board (FSB). The FSB was established in April 2009 by the Group of 20 (G20) leaders; it is a not-for profit association under Swiss law, based at Basel. The FSB's basic structure and mandate built directly on those of its predecessor (the Financial Stability Forum). It coordinates at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. It brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSB's mandate is to:

- assess vulnerabilities affecting the financial system and identify and oversee action needed to address them
- promote co-ordination and information exchange among authorities responsible for financial stability
- monitor and advise on market developments and their implications for regulatory policy
- advise on and monitor best practice in meeting regulatory standards
- undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps
- set guidelines for and support the establishment of supervisory colleges
- manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms
- collaborate with the IMF to conduct Early Warning Exercises.

Members of the FSB are committed to: maintaining financial stability; ensuring that the financial sector is open and transparent; implementing international financial standards; and undergoing periodic peer reviews, using amongst other evidence, the joint IMF/World Bank Financial Sector Assessment Program reports.

The FCA is also an active member of the International Organisation of Securities Commissions, the International Association of Insurance Supervisors and works closely with the PRA on relevant issues at the Basel Committee on Banking Supervision (Basel).

3.2.1 Financial Advice Market Review

We began this Part with an historical review of the development of financial services and within its text we have considered further changes, perhaps the most significant being the Retail Distribution Review. But the space needs to be watched ... closely!

The need in the 1980s was perceived to be the regulation of financial services to protect the consumer. Successive and far-reaching tranches of regulation have encouraged advisers' professional standards and emphasised their obligation to put clients' interests before their own. Meanwhile the costs of being a financial adviser in terms of monetary expenses and time – to name just a few: initial training, professional indemnity insurance, ongoing professionalism and fees to regulators and professional bodies – are significant and increasing. Severe penalties have been introduced and huge fines imposed. Some advisers have protested, in the trade Press for example, that the financial services industry is being used as a cash cow by the Treasury which gleefully takes surpluses from fines etc. away from the FCA into the general taxation pot.

Against this background, many advisers – if they have decided not to leave the industry altogether – feel unable to advise “ordinary” members of the public and instead concentrate their resources on those clients who can afford the fees. This has tended to remove advice from the “man in the street” and he is perhaps most in need of financial advice. The Government recognised this with the introduction for example of the Money Advice Service and Pension Wise. But it was not enough.

The Government therefore announced the Financial Advice Market Review to examine how financial advice, considered in its broadest sense, could work better for consumers. The Review, published on 14 March 2016, made a number of policy recommendations in the general areas of affordability, accessibility and liabilities & consumer redress including:

Affordability of Advice

- The Treasury should consult on amending the definition of regulated advice in the existing Regulated Activities Order (RAO).
- The FCA should consult on new guidance to support firms offering services that help consumers making their own investment decisions without a personal recommendation.
- The Review recommends developing a clear framework that gives firms the confidence to provide streamlined advice on simple consumer needs in a proportionate way,
- The Review recommends giving firms more flexibility to train a new generation of advisers by allowing employees to work for up to four years under supervision to obtain an appropriate qualification and experience.
- The FCA and industry should continue to work together with the aim of bringing about improvements to suitability reports, reducing their length, where appropriate, and the time firms spend preparing them.

Accessibility of Advice

- The FCA and The Pensions Regulator (TPR) should develop and promote a new factsheet to set out what help employers and trustees can provide on financial matters without being subject to regulation.
- HMT should explore ways to improve the existing £150* income tax and National Insurance exemption for employer-arranged advice on pensions.
- The Treasury should explore options to allow consumers to access a small part of their pension pot before the normal minimum pension age, to redeem against the cost of pre-retirement advice.
- The Treasury should challenge the industry to make a pensions dashboard available to consumers by 2019, bringing together industry and consumer representatives to help them set direction and drive progress.

Liabilities and consumer redress

- The FCA regularly undertakes funding reviews of the Financial Services Compensation Scheme (FSCS), and FAMR recommends that the 2016 FSCS Funding Review, should specifically explore risk-based levies.
- Following its review of FSCS funding, in light of evidence received as to the impact of the professional indemnity insurance (PII) market on FSCS funding, the FCA should consider whether to undertake a review of the availability of PII cover for smaller advice firms.
- The Financial Ombudsman Service should consider undertaking regular 'Best Practice' roundtables with industry and trade bodies where both sides can discuss relevant issues such as the evidence used when considering historic sales and suitability requirements.

It is inevitable that we will see many of these recommendations making their way into regulatory practice and requirements and many are being actively considered.

** already the above £150 has been increased to £500 with effect from 6 April 2017 and complementing this the Pension Advice Allowance has been introduced to enable employees themselves to access their pension fund on three occasions over their lifetime to pay for regulated advice.*

3.3 PRUDENTIAL REGULATION AND FINANCIAL CRIME

The Prudential Regulation Authority has prudential responsibility for all deposit takers, insurers and significant investment firms. The FCA has responsibility for other sectors across the financial services industry; as such, the FCA regulates the prudential standards of 23,000 (2014 data) firms.

Prudential regulation, a concept emerging over the last decade or so from modern economic theory, concerns the regulation of a firm's financial framework. The UK Corporate Governance Code - Cadbury Report, published over a quarter of a century ago in 1992, is seen by many as the foundation of modern world-wide corporate governance. It set out recommendations in the wake of corporate failures, such as those precipitated following the failures of Polly Peck, BCCI and the death of Robert Maxwell. Modern well-run companies try to follow these recommendations. In essence the recommendations concerned, and still do, the raising of standards of reporting and accountability: the high standards are intended to foster public trust and confidence in UK business. It is coincidental that Maxwell's legacy was particularly significant in financial services, affecting as it did the Mirror Group employees' pension rights. More work needs to be done: since 1992 Enron, AIG, Lehman, World Com and Carillion have collapsed. And most students will be familiar with the collapse of BHS, the interrogation in June 2016 and subsequent condemnation by the Work & Pensions and Business, Innovation and Skills Commons Select Committees of BHS's former owner Sir Philip Green. This was followed by Theresa May's statement later in 2016 to take steps to curb excessive executive pay, while Carillion's failure brought the following condemnation from Jeremy Corbyn: "In the wake of the collapse of the contractor Carillion, it is time to put an end to the rip-off privatisation policies that have done serious damage to our public services and fleeced the public of billions of pounds." And to avoid any political bias, even the Tory ex-Chancellor Lord Lawson referred to "a degree of moral hazard which we see very much in the Carillion affair".

The objective of prudential regulation, which can be seen* as part of corporate governance, is to protect the stability of the financial system, protect deposits and foster public trust and confidence in the financial services system. In other words, assessing the adequacy of a firm's financial resources in relation to all the activities of the firm and the risks to which they give rise. Adequate financial resources and systems and controls are necessary for the effective management of prudential risks, including financial crime risks. The FCA's rules in this area can be found in the "Prudential Standards" block of the FCA Handbook (see 3.4.2 below). These standards are jointly imposed by the FCA and PRA.

** In their Consultation Paper CP18/15, Corporate governance: Board responsibilities, May 2015, the PRA observe "Failures of governance or the management of risk by boards have been a key factor in many of the major financial sector failures of recent years. It is axiomatic therefore that the PRA has a major interest in promoting good governance across the financial sector and supporting the work of boards in delivering it."*

The FCA expects senior management to take responsibility for managing financial crime risks, which should be treated in the same manner as other risks faced by the business. The main areas of financial crime faced by firms will be money laundering (see 4.5 for more details) and fraud. There should be evidence that senior management are actively engaged in the firm's approach to addressing the risks.

Firms' organisational structures to combat financial crime may differ. Some large firms will have a single unit that coordinates efforts and which may report to the head of risk, the head of compliance or directly to the CEO. Other firms may spread responsibilities more widely. Whichever approach is used, the firm's structure should promote coordination and information sharing across the business.

Firms must have a thorough understanding of its financial crime risks if they are to apply proportionate systems and controls. Therefore, firms must have in place up-to-date policies and procedures appropriate to its business. These should be readily accessible, effective and understood by all relevant staff.

Firms must employ people who possess the skills, knowledge and expertise to carry out their functions effectively. Their competence should be regularly reviewed and, where necessary, appropriate action should be taken to ensure they remain competent for their role. Vetting and training should be appropriate to employees' roles.

In the context of tightening Governance requirements, it is worth noting that the Chair of occupational DC schemes needs to provide a Governance Statement from April 2015 and from the same date, Investment Governance Committees (or alternatively a Governance Advisory Arrangement for smaller and less complex schemes) are required by FCA to oversee workplace pension schemes.

3.3.1 Fraud and Financial Crime

This is a significant issue for UK consumers and relevant regulators. It takes various forms: share sale fraud (or "boiler room fraud") for example and other investment scams, e.g. involving land, banking and unauthorised deposit taking. The proceeds of these crimes are increasingly ending up in "collection accounts" held with UK high-street banks. There is a common pattern of activity for such accounts. They typically receive large numbers of relatively small payments from individuals before making substantial, regular payments to other accounts, usually based overseas, as the criminals disperse their proceeds.

Firms have obligations under the Proceeds of Crime Act 2002, the Money Laundering Regulations 2007 (& subsequent updates and Directives) and FCA rules to:

- have appropriate systems and controls that identify, assess, monitor and manage money laundering risk;
- appoint a suitable individual to oversee these systems and controls.

Firms should identify and report transactions where they are suspicious of financial crime. This will help prevent consumer loss by enabling the relevant authorities to identify quickly the proceeds of unauthorised business and, where appropriate, freeze funds. We will consider anti-Money Laundering measures further in section 4.5 of this Part.

3.3.2 Data Security

The FCA expects firms to put in place systems and controls that will minimise the risk that their operation and information assets might be exploited by criminals. Internal procedures such as IT controls and physical security measures should be designed to protect against unauthorised access to customer data. This aspect is considered further in section 4.6 of this Part.

3.3.3 Bribery and Corruption

Bribery, wherever it is committed, is a criminal offence under the Bribery Act 2010, which consolidates and replaces previous anti-bribery and corruption legislation. The Bribery Act also introduced a new offence for commercial organisations of failing to prevent bribery. However, if a firm can show it had adequate bribery- prevention procedures in place this can be used as a defence. The Ministry of Justice has published guidance on adequate anti-bribery procedures.

The FCA does not enforce or give guidance on the Bribery Act. It may, however, take action against a firm with deficient anti-bribery and corruption systems and controls, since Principle 1 of the FCA's Principles for Business requires authorised firms to conduct their business with integrity. Firms should take this into account when considering the adequacy of their anti-bribery and corruption systems and controls.

3.4 FCA HANDBOOK AND BUSINESS STANDARDS

The FCA Handbook sets out the main regulatory obligations for firms and individuals. It brings together the various sourcebooks and handbooks that make up the body of the FCA rules. It is a lengthy document, continually updated on line, made up of discrete sections which can be accessed separately, e.g. PRIN, discussed below, gives the FCA's Statement of Principles for Business. The Handbook is broken down into nine Blocks of material plus a Glossary of terms, as is shown in the table reproduced at the end of this paragraph. The layout of the Handbook is shown in full though not all elements are directly relevant to the DRR. Those that are relevant are considered in further detail, both in this Chapter and later in this Module (the Listing entry in the table below was also briefly referred to earlier in section 1.2 of Chapter 1 in this Part).

| BLOCK | WHAT IS COVERED |
|------------------------------------|---|
| High Level Standards | the standards applying to all firms and approved persons |
| Prudential Standards | the prudential requirements for firms |
| Business Standards | the detailed requirements relating to firms' day-to-day business |
| Regulatory Processes | the manuals describing the operation of the FCA's and PRA's authorisation, supervisory and disciplinary functions |
| Redress | the processes for handling complaints and compensation |
| Specialist sourcebooks | requirements applying to individual business sectors |
| Listing, Prospectus and Disclosure | United Kingdom Listing Authority rules |
| Handbook Guides | guides to the Handbook which are aimed at giving a basic overview of certain topics and point firms in the direction of material in the Handbook applicable to them |
| Regulatory Guides | guides to regulatory topics |
| Glossary | the meaning of defined terms used in the Handbook |

The Blocks set out in the above table will now be considered in further detail (where relevant to retail financial services).

3.4.1 High Level Standards

The first Block within the Handbook covers the standards that apply to all firms and approved persons.

High Level Standards

| Sourcebook or manual | What it includes |
|--|--|
| Principles for Businesses (PRIN) | the fundamental obligations of all firms under the regulatory system |
| Senior Management Arrangements, Systems and Controls (SYSC) | the responsibilities of directors and senior management |
| Code of Conduct (COCON) | rules about the conduct of approved person and persons who are employees of relevant authorised persons |
| Threshold Conditions (COND) | the minimum standards for becoming and remaining authorised |
| Statements of Principle and Code of Practice for Approved Persons (APER) | the fundamental obligations of approved persons |
| The Fit and Proper test for Approved Persons (FIT) | the minimum standards for becoming and remaining an approved person |
| Financial Stability and Market Confidence Sourcebook (FINMAR) | Provisions relating to financial stability, market confidence and short selling |
| Training and Competence (TC) | the commitments and requirements concerning staff competence |
| General Provisions (GEN) | interpreting the Handbook, fees, approval by the FCA and PRA, emergencies, status disclosure, the FSA logo and insurance against fines |
| Fees Manual (FEES) | the fees provisions for funding the FCA and PRA, FOS and FSCS |

Principles for Businesses (PRIN) sets out a general statement of the fundamental obligations placed on all authorised firms under the regulatory system.

Senior Management Arrangements, Systems and Controls (SYSC) requires the senior management of authorised businesses to have an adequate structure of systems and controls for the business. The purpose of SYSC is to:

- encourage firms' directors and senior managers to take appropriate practical responsibility for their firms' arrangements on matters likely to be of interest to the FCA because they impinge on the FCA's functions under the FSMA
- increase certainty by taking reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems
- encourage firms to vest responsibility for effective and responsible organisation in specific directors and senior managers
- create a common platform of organisational and systems and controls requirements for all firms.

The Code of Conduct rules (COCON) set out responsibilities of Senior Managers in particular including the requirement to deal with the FCA inter alia with personal integrity. The COCON rules replace the previous APER rules for those retail investment advisers working within banks, building societies and credit unions who are subject to the new Senior Manager and Certification Regime. We look in more detail at the COCON rules in Part 2 section 1.4 where we consider the overarching Code of Ethics.

The Threshold Conditions (COND) are the minimum conditions which a firm is required to satisfy, and continue to satisfy, in order to be given and to retain Part 4A permission to conduct regulated activity. The Financial Services Act 2012 gave HM Treasury the power to amend schedule 6 of the FSMA. HM Treasury exercised this power by making the Financial Services and Markets Act 2000 (Threshold Conditions) Order 2013 which came into force on 1 April 2013. Its main effect was the creation of four sets of Threshold Conditions, namely:

- conditions for firms authorised and regulated by the FCA only
- FCA specific conditions for firms authorised by the PRA and subject to dual regulation
- PRA specific conditions for insurers
- PRA specific conditions for other PRA authorised persons.

The Threshold Conditions are:

1. **Legal Status** – If the regulated activity is effecting contracts of insurance the authorised person must be a body corporate (other than a limited liability partnership), a registered friendly society or a member of Lloyd's. If the person concerned appears to the FCA to be seeking to carry on, or to be carrying on, a regulated activity constituting accepting deposits, it must be a body corporate; or partnership.
2. **Location of offices** – If a body corporate constituted under the law of the UK, its head office and its registered office must be in the UK. Alternatively, if not a body corporate but has a head office in the UK it must carry on business in the UK.
3. **Effective supervision** – The firm must be capable of being effectively supervised by the FCA.
4. **Appropriate resources** – The firm's resources, financial and non-financial, must be appropriate for the regulated activity undertaken.
5. **Suitability** – The person concerned must satisfy the FCA that he is a fit and proper person having regard to all the circumstances, including his connection with any person, the nature of any regulated activity that he carries on or seeks to carry on, and the need to ensure that his affairs are conducted soundly and prudently.
6. **Business model** – The business model must be suitable for the regulated activity undertaken. Need to ensure the model ensures affairs are conducted soundly and prudently and in the interests of consumers.

The main obligations for individuals can be found in the Statements of Principle and Code of Practice for Approved Persons (APER). Further details on these, including criteria for the Fit and Proper test for Approved Persons (FIT), will be covered in the next Chapter (in section 4.2).

3.4.2 Prudential Standards

This Block sets out the prudential requirements for firms. In broad terms this is the firm's financial framework.

Prudential Standards

| Sourcebook or manual | What it includes |
|---|--|
| General Prudential sourcebook (GENPRU) | General Prudential Sourcebook for Banks, Building Societies, Insurers and Investment Firms |
| Prudential sourcebook for Banks, Building Societies and Investment Firms (BIPRU) | Prudential Sourcebook for Banks, Building Societies and Investment Firms |
| Prudential sourcebook for Investment Firms (IFPRU) | Prudential sourcebook for Investment Firms |
| Prudential sourcebook for Insurers (INSPRU) | Prudential sourcebook for Insurers |
| Prudential sourcebook for Mortgage and Home Finance Firms, and Insurance Intermediaries (MIPRU) | the prudential requirements for mortgage and home finance firms and insurance intermediaries |
| Interim Prudential sourcebook for Friendly Societies (IPRU-FSOC) | the prudential and notification requirements for friendly societies |
| Interim Prudential sourcebook for Insurers (IPRU-INS) | the residual prudential and notification requirements for insurers |
| Interim Prudential sourcebook for Investment Businesses (IPRU-INV) | the prudential and notification requirements for investment firms |

GENPRU includes rules which require a firm to identify and assess risks to its being able to meet its liabilities as they fall due, how it intends to deal with those risks, and the amount and nature of financial resources that the firm considers necessary. A firm should document that assessment. The FCA will review that assessment as part of its own assessment of the adequacy of a firm's capital under its Supervisory Review and Evaluation Process. When forming a view of any individual capital guidance to be given to the firm, the FCA will also review its risk assessment and any other issues arising from day-to-day supervision.

A firm is required to carry out appropriate stress tests and scenario analyses for the risks it has previously identified and to establish the amount of financial resources needed in each of the circumstances and events considered in carrying out the stress tests and scenario analyses.

A firm must at all times maintain overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

The liabilities referred to in the overall financial adequacy rule include a firm's contingent and prospective liabilities. They exclude liabilities that might arise from transactions that a firm has not entered into and which it could avoid, for example, by taking realistic management actions such as ceasing to transact new business after a suitable period of time has elapsed. They include liabilities or costs that arise both in scenarios where the firm is a going concern and those where the firm ceases to be a going concern. They also include claims that could be made against a firm, which ought to be paid in accordance with the fair treatment of customers, even if such claims could not be legally enforced.

Risks may be addressed through holding capital to absorb losses that unexpectedly materialise. The ability to pay liabilities as they fall due also requires liquidity. Therefore, in assessing the adequacy of a firm's financial resources, both capital and liquidity needs should be considered.

3.4.3 Business Standards

This Block contains the detailed requirements relating to a firm's day-to-day business.

Business Standards

| Sourcebook or manual | What it includes |
|---|--|
| Conduct of Business Sourcebook (COBS) | the conduct of business requirements applying to firms with effect from 1 November 2007 |
| Insurance: Conduct of Business sourcebook (ICOBS) | the non-investment insurance conduct of business requirements |
| Mortgages and Home Finance: Conduct of Business sourcebook (MCOB) | the requirements applying to firms with mortgage business customers |
| Banking: Conduct of Business sourcebook (BCOBS) | the requirements applying to banks |
| Client Assets (CASS) | the requirements relating to holding client assets and client money |
| Market Conduct (MAR) | Code of Market Conduct, Price stabilising rules, Inter-professional conduct, Endorsement of the Takeover Code, Alternative Trading Systems, what is acceptable market conduct and what is market abuse |

The purpose of the COBS rules is to set out detailed guidance on how staff and representatives of regulated businesses should deal with customers. It applies to all regulated firms classed as life and pensions and investment businesses.

Firms are required to act honestly, fairly and professionally in accordance with the best interests of their clients (the client's best interests rule). They should also provide appropriate information in a comprehensible form to a client about the firm and its services, designated investments and proposed investment strategies, execution venues, and costs and associated charges, so that the client is reasonably able to understand the nature and risks of the service and of the specific type of designated investment that is being offered and, therefore, is able to take investment decisions on an informed basis.

Inducements: A firm must not pay or accept any remuneration (fee or commission), or provide or receive any non-monetary benefit, in relation to designated investment business if it is likely to conflict, to a material extent, with any duty owed to the customer.

If a firm is required to disclose remuneration to a client in relation to the sale of a packaged product (other than in relation to arrangements between firms that are in the same immediate group) the firm should not enter into:

- volume overrides, if remuneration paid in respect of several transactions is more than a simple multiple of the remuneration payable in respect of one transaction of the same kind
- an agreement to indemnify the payment of remuneration on terms that would or might confer an additional financial benefit on the recipient in the event of the remuneration becoming repayable.

Reasonable non-monetary benefits: In relation to the sale of packaged products, reasonable non-monetary benefits which are capable of enhancing the quality of the service provided to a client and, depending on the circumstances, are capable of being paid or received without breaching the client's best interests rule are allowed. However, in each case, it will be a question of fact whether these conditions are satisfied.

Details of reasonable non-monetary benefits are given in COBS 2.3.15. They include:

- selling – product literature without the intermediary's name; product promotion to enhance customer service; intermediary seminars attended for genuine business purposes
- communications – reasonable travelling and accommodation costs of an intermediary visiting a UK office; pre-paid envelopes; Freephone link if available to intermediaries generally
- training – facilities can be supplied if made generally available for intermediaries.

Records must be kept of any benefits given to an intermediary for at least five years from the date on which it was given.

ICOBS applies to firms selling and marketing general insurance and pure protection life assurance. Under *ICOBS*, insurers and intermediaries require authorisation to carry out regulated business, and the rules apply to renewals as well as to new business. Before offering advice, intermediaries must supply customers with an initial disclosure document or terms of business which gives details of the services offered and their authorisation status. They must then obtain details of the client's circumstances, together with any existing policies and give the client a statement of those demands and needs together with any recommendations. Customers have the right to cancel a policy without penalty and without giving any reason within 14 days for general insurance and within 30 days for pure protection contracts and Payment Protection Insurance. The right to cancel does not apply to:

- a travel and baggage policy or similar short-term policy of less than one month's duration
- a policy the performance of which has been fully completed by both parties at the consumer's express request before the consumer exercises his right to cancel
- a pure protection contract of six months' duration or less
- a pure protection contract effected by the trustees of an occupational pension scheme, an employer or a partnership to secure benefits for the employees or the partners in the partnership
- a general insurance contract sold by an intermediary who is an unauthorised person (other than an appointed representative).

3.4.4 Regulatory Processes

This Block contains the manuals describing the operation of the FCA's authorisation, supervisory and disciplinary functions.

Regulatory Processes

| Sourcebook or manual | What it includes |
|---|--|
| Supervision (SUP) | supervisory provisions including those relating to auditors, waivers, individual guidance, notifications and reporting |
| Decision Procedure and Penalties Manual | a description of the FCA's procedures for taking (DEPP) statutory notice decisions, the FCA's policy on the imposition and amount of penalties (and other disciplinary procedures) and the conduct of interviews |

The Supervision manual (SUP) (see 3.5 below) and the Decision, Procedure and Penalties manual (DEPP) form the regulatory processes part of the Handbook.

SUP sets out the relationship between the FCA and authorised persons (referred to in the Handbook as firms). As a general rule, material that is of continuing relevance after authorisation is in SUP.

DEPP is principally concerned with and sets out the FCA's decision making procedures that involve the giving of statutory notices, the FCA's policy in respect to the imposition and amount of penalties, and the conduct of interviews to which a direction under s169(7) of the FSMA has been given or the FCA is considering giving.

Where a firm undertakes business internationally (or is part of a group which does), the FCA will take this into consideration when looking at the context in which it operates, including the nature and scope of the regulation to which it is subject in jurisdictions other than the UK. Where a firm's head office is outside the UK, the regulation in the jurisdiction where the head office is located will be particularly relevant. As part of its supervision of such a firm, the FCA will usually seek to cooperate with relevant overseas regulators, including exchanging information on the firm. Different arrangements apply for an incoming EEA firm, an incoming Treaty firm and a UCITS qualifier.

3.4.5 Redress

This Block gives details of the processes for handling complaints and compensation.

| Sourcebook or manual | What it includes |
|--|---|
| Dispute Resolution: Complaints (DISP) | the detailed requirements for handling complaints and the Financial Ombudsman Service arrangements |
| Consumer Redress Schemes Sourcebook (CONRED) | The requirements for all firms that advised, arranged or managed investments where there has been widespread or regular failure as a result of which consumers have suffered (e.g. Arch cru fund) |
| Compensation (COMP) | the rules governing eligibility under, and levies for, the Financial Services Compensation Scheme |

Further information on dispute resolution and compensation was given in Chapter 1 above.

3.4.6 Specialist Sourcebooks

This Block contains the requirements applying to individual business sectors. The areas covered are:

- Collective Investment Schemes (COLL)
- Credit Unions New sourcebook (CREDS)
- Consumer Credit Sourcebook (CONC)
- Investment Funds sourcebook (FUND)
- Professional Firms (PROF)
- Regulated Covered Bonds (RCB)
- Recognised Investment Exchanges (REC).

3.4.7 Listing, Prospectus and Disclosure

This Block contains the following United Kingdom Listing Authority rules:

- Listing Rules (LR): United Kingdom Listing Authority listing rules
- Prospectus Rules (PR): United Kingdom Listing Authority prospectus rules
- Disclosure Rules and Transparency Rules (DTR): United Kingdom Listing Authority disclosure rules.

3.4.8 Handbook Guides

This Block contains guides to the Handbook which aim to give a basic overview of certain areas. The guides in this Block are:

- Energy Market Participants Guide (EMPS)
- Oil Market Participants Guide (OMPS)
- Service companies Guide (SERV).
- General guidance on Benchmark Submission and Administration (BENCH).

3.4.9 Regulatory Guides

This Block contains guides to regulatory topics:

- The Collective Investment Scheme Information Guide (COLLG)
- The Enforcement Guide (EG)
- Financial Crime: a guide for firms (FC)
- The Perimeter Guidance Manual (PERG)
- The Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD)
- The Unfair Contract Terms Regulatory Guide (UNFCOG)
- The Wind-down Planning Guide (WDPG).

The most relevant of these guides for the financial adviser is PERG. It gives guidance about the circumstances in which authorisation is required, exempt person status is available, and gives guidance on which activities are regulated.

3.4.10 Complaints Against Regulators

The Financial Services Act 2012 requires the Financial Conduct Authority, the Prudential Regulation Authority and the Bank of England to have arrangements for the investigation of complaints against them. These arrangements are known as the Complaints Scheme which has effect from April 2013. The Complaints Scheme deals with complaints against the FCA and is a two stage process.

In the first stage the Regulators will investigate any complaint that meets the requirements of the Scheme and take whatever action to resolve the matter they think is appropriate. In the second stage the Complaints Commissioner, an independent person appointed by the Regulators, will investigate complaints that are referred to him following a stage one investigation where the complainant remains dissatisfied.

Section 20 of the Small Business, Enterprise and Employment Act 2015 has inserted new subsections 9A and 9B into Section 87 of the 2012 Act (investigations of complaints against Regulators). These new subsections require the investigator (the Complaints Commissioner) for the Regulators' Scheme to produce an annual report on his or her investigations.

3.5 SUPERVISION

The FCA's strategic objective is to ensure that the relevant markets function well. To support this, they deliver their work through three operational objectives:

- to secure an appropriate degree of protection for consumers;
- to protect and enhance the integrity of the UK financial system;
- to promote effective competition in the interests of consumers.

The Supervision objective, outlined in the Regulatory Processes covered in the FCA Handbook, is that the FCA will adopt a pre-emptive approach which will be based on making forward-looking judgments about firms' business models, product strategy and how they run their businesses, to enable the FCA to identify and intervene earlier to prevent problems crystallising. The FCA supervision model of risk assessment applies to all firms, although the detail required may vary from firm to firm. For example, some firms may experience a highly intensive level of contact although others may only be contacted once every four years. Firms judged as high impact are likely to require a more detailed assessment. A peer review process within the FCA assists consistency and will be focused on firms and sectors of the industry that could cause or are causing consumers harm or threaten market integrity.

The FCA will intervene if there are unacceptable risks to the fair treatment of customers or the integrity of the market. The overall approach in the FCA supervision model is based on the following principles:

- (1) forward looking and more interventionist;
- (2) focused on judgment, not process;
- (3) consumer-centric;
- (4) focused on the big issues and causes of problems;
- (5) interfaces with executive management/Boards;
- (6) robust when things go wrong;
- (7) focused on business model and culture as well as product supervision;
- (8) viewing poor behaviour in all markets through the lens of the impact on consumers;
- (9) orientated towards firms doing the right thing; and
- (10) externally focused, engaged and listening to all sources of information.

The supervision model is based on three pillars:

- Pillar 1 – proactive supervision for the biggest firms by means of a structured conduct assessment.
- Pillar 2 – event-driven, reactive supervision of actual or emerging risks.
- Pillar 3 – thematic work that focuses on risks and issues affecting multiple firms or a sector as a whole.

Where a structured conduct assessment has taken place, to assist firms to raise standards and to maximise the success of the FCA's supervisory arrangements, it is important that a firm understands the FCA's evaluation of its risk so that it can take appropriate action.

The FCA intends to communicate the outcomes of its pillars of supervision to each firm within an appropriate time frame. In the case of firms in which risks have been identified which could have a material bearing on the FCA meeting its statutory objectives, the FCA will also outline a remedial programme intended to address these.

The FCA considers that it would generally be inappropriate for a firm to disclose its FCA risk assessment to third parties, except to those who have a need or right to be aware of it, for example external auditors. FCA risk assessments are directed towards a specific purpose - namely illustration of the risks posed by a firm to the FCA's statutory objectives and to enable the FCA to allocate its resources accordingly. Using a risk assessment for any other purpose has the potential to be misleading. The FCA therefore discourages firms from disclosing their assessments, unless they are required to make them public under relevant disclosure obligations.

3.5.1 Risk Management: Impact and Probability Assessment

The FCA defines risk to be the combination of impact (the potential harm that could be caused) and probability (the likelihood of the particular issue or event occurring).

The FCA combines these impact and probability factors to give them a measure of the overall risk posed to statutory objectives. They use this measure to prioritise risks and make decisions on what, if anything, the regulatory response should be. They also use it to set our strategic aims and outcomes and to allocate resources based on our regulatory priorities.

This approach is designed to:

- identify the main risks to our objectives as they arise
- measure the importance of the risk
- mitigate risks
- monitor the progress of the risk.

The FCA manages risk in two ways:

- **The firms approach** involves assessing and dealing with risks to an individual firm or group of connected firms.
- **The thematic approach** involves managing risks which affect a number of firms, an entire sector or the market as a whole. (reference was made to Thematic Reviews at the start of section 3.2 and we consider further in section 3.5.4.)

The FCA chooses one or the other of these approaches (or both) to deal with risks in the most efficient and effective way.

3.5.2 Risk management: Identification, Measurement, Mitigation and Monitoring

Risk identification

Firstly the FCA identifies risks to the statutory objectives. This is done through intelligence gathering from a variety of sources (e.g. this can be through visits to firms as part of their supervision or enforcement action; information provided by firms - monitoring of regulatory returns and similar data; transaction monitoring; sector and environmental analysis; project work etc.).

The FCA regularly consults a wide range of stakeholders, including market participants and its Consumer and Practitioner Panels, and also uses information supplied by the Ombudsman on industry trends and problems revealed through complaints.

Risk measurement

Next the identified risks are measured. This involves scoring the risk against several probability and impact factors. Both of these are weighted as high, medium-high, medium-low or low. The probability factors relate to the likelihood of the event happening, and the impact factors indicate the scale and significance of the problem if it were to happen. Combining the probability and impact factors gives a measure of the overall risk posed to its objectives.

Risk mitigation

The measure of the overall risk is used to prioritise the risks, help make decisions on the regulatory response and, together with an assessment of the costs and benefits of using alternative regulatory tools help us to determine resource allocation.

Risk monitoring & reporting

Risk management systems provide FCA management with regular reports to give assurance that risks are being managed appropriately and that internal controls are adequate.

3.5.3 Skilled Persons Reviews

The Glossary to the Handbook describes a Skilled Person as (briefly) a person appointed to make reports required by FSMA for provision to the appropriate regulator and who must be a person:

- nominated, approved or appointed by the appropriate regulator
- appearing to the appropriate regulator to have the skills necessary to make a report on the matter concerned.

Typically the Skilled Person will be a national auditor or other firm/company of standing within the financial services community.

A Skilled Person Review is one of the regulatory tools the FCA can employ under FSMA as amended by the Financial Services Act 2012.

There are two types of Skilled Person Review under FSMA as amended by the 2012 Act that give the FCA the power to commission reviews by Skilled Persons as required:

- s166 Reports by Skilled Persons; and/or
- s166A Appointment of Skilled Person to collect and update information.

The FCA uses these powers to obtain an independent view of aspects of a firm's activities where they have cause for concern or where they require further analysis. To enable the FCA to use this new power in line with the European Procurement Directive and the Public Contracts Regulations 2006, as amended by the 2014 Public Contracts Directives, a panel of Skilled Person Firms has been developed. The Panel is operational from 1 April 2013 until 31 March 2021 (extended from 31 March 2017 and is monitored on a regular basis. The Panel has been developed to ensure a consistent, high quality and transparent approach to conducting Skilled Person Reviews.

3.5.4 Thematic Reviews

Thematic reviews form a significant part of the FCA's approach to supervision. The FCA uses thematic reviews to assess a current or emerging risk relating to an issue or product across a number of firms within a sector or market. Such reviews can be focused on both discovering what is going on and on how the FCA suggest the issue is tackled. They also refer to this as 'issues and products' work or 'cross-firm' work.

The FCA can apply the thematic process to a large variety of situations, firms and groups of consumers. It allows investigation into key risks, and its focus on a specific risk allows for further detailed work in the particular area of concern. In its 2016/17 Business Plan, the FCA confirmed ongoing and new thematic and market reviews affecting the retail investment business area (there are other reviews affecting banking, consumer credit, etc.) as follows:

- Fair Treatment of With Profit Holders
- Retirement Outcomes review
- Non-advised drawdown sales
- Assessing Suitability of advice follow-up
- Outcomes Testing on auto-advice

Thematic work is undertaken by people with specialised expertise, which enables the FCA to tackle complex issues by deploying resource appropriately and efficiently aiming for better results. The FCA's thematic team delivers the outcomes through extensive desk-based review of information combined with the site visits, as well as by working closely with industry practitioners and trading professional bodies.

An example of a pensions-relevant thematic review is that published by the FCA in February 2014: TR14/2 – Thematic Review of Annuities. This was the result of a study into annuities and other retirement income products started in January 2013. This review, in the words of the FCA “suggests that some parts of the market are not working well for consumers”. They identified in the review the following areas as concerns:

- The majority of consumers (60%) do not switch providers when they buy an annuity, despite the fact that the FCA estimate 80% of these consumers could get a better deal on the open market, many significantly so.
- The FCA estimate that the aggregate benefits which consumers miss out on by not shopping around and switching is the equivalent of between £115m and £230m of additional pension savings.
- In part consumers miss out on the benefits available from shopping around and switching due to their lack of engagement in pensions and annuities, the confusing trade-offs they face and the impact of behavioural biases. (As an illustration as to how the thematic review process interacts with specialists, the FCA commissioned a separate report: Pension annuities: a review of consumer behaviour as part of their research.)
- There is an incentive on providers to retain their existing pension customers, as overall the estimated levels of expected profitability of standard annuity business sold to existing pension customers is more than the expected profitability of annuity business sold on the open market.
- The differences in retention rates (i.e. proportion of pensions annuitizing with their pension provider rather than switching) between firms varies widely and some firms have relatively high retention rates and have active retention strategies that may increase customer loyalty and reduce the propensity to shop around.
- There are particular groups of consumers where it appears that the market is not working well. There is an apparent lack of choice and ability to switch for those with small pension funds and lower annuity rates available to these consumers generally, which is likely in part to be due to the fixed costs of providing an annuity representing a larger proportion of the customer's funds.
- There is a lack of access to enhanced annuity rates for some consumers annuitizing with their existing pension provider and not shopping around.

The review highlighted the number of small pensions pots, currently estimated as in excess of a million dormant pots valued at under £5,000. Without change, it is anticipated that this number will grow substantially with the Government's workplace pension reforms, automatic enrolment. A further estimate was that there could be around 50 million dormant workplace DC pension pots by 2050, and that over 12 million of these would be under £2,000 (in today's terms).

The FCA proceeded with a more detailed market study, market studies being their “new main tool for examining competition issues in the markets [the FCA] regulate ? they allow [them] to look more broadly at a market to analyse how competition works today, and how it might develop. The results of the thematic review have been used in developing the scope of the market study, and will inform that ongoing work.”

To gauge the effect and relevance of a thematic review like TR14/2 – Thematic Review of Annuities it is worth considering the concomitant discussions around the proposed (but now postponed) introduction of “pot follows member” and the unexpected March 2014 Budget announcement which has produced legislation allowing members to take, subject to income tax, the whole of their pension pot as immediate cash. No doubt other factors are at work behind both of these developments but is not TR14/2 – Thematic Review of Annuities both relevant to and connected with these developments? The influence of this Thematic Review could reach further than its stated intent.

Thematic Reviews represent one “paper” tool used by the FCA. The FCA's supervision also uses others such as Consultation Papers, Discussion Papers and Policy Statements which are applied to areas of concern from time to time. The student will see references to these other tools in this manual.

Summary

This Chapter has analysed the FCA's responsibilities and approach to regulation. This included the FCA Handbook and business standards, the regulatory processes and the principles of risk-based supervision.

Self Test Questions

- What is prudential regulation?
- What are the Blocks in the FCA Handbook and what do they cover?
- How does the FCA use Thematic Reviews?
- Describe the five Threshold Conditions that make up the minimum conditions a firm is required to satisfy.
- Explain the FCA's risk-based approach to supervision.

CHAPTER 4

Principles and Rules

INTRODUCTION

In this Chapter we set out the principles and rules within the regulatory framework. This includes looking at what falls under the definition of regulated activities and at the responsibilities of approved persons. We refer to principles and rules here in the general sense. The FCA refer to specific “Principles” in their literature. Bear in mind also that the nature of regulation has changed from its inception. Three decades ago, the regulator concentrated more on precise rules (a starting basis needed to be laid down for regulation at that time). Today, in the light of experience, the regulatory approach is more attuned to Outcomes as they affect the consumer.

Within the principles and rules framework, advisers need to follow the proper record keeping requirements which also need to conform to the data protection requirements. Proper record keeping is also essential to ensure that advisers comply with the anti-money laundering and proceeds of crime requirements.

This Chapter will also explain the complaints procedure and the roles of the Financial Ombudsman Service and the Financial Services Compensation Scheme.

4.1 REGULATED ACTIVITY

Under s19 of FSMA, any person who carries out a regulated activity in the UK must be authorised by the FCA or exempt (i.e. an appointed representative of an authorised firm or some other exemption). Firms need to establish whether they need authorisation to carry on regulated activities and this includes intermediaries selling investments and/or home finance activities and/or general insurance. For each regulated activity, firms must also identify for each activity the investment type concerned.

Any person who carries out regulated activities without being authorised may find that they have committed a criminal offence which is punishable on indictment by a maximum term of two years’ imprisonment and/or a fine.

The activities and specified investments are detailed in The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) as amended.

Regulated activities are fully explained in Part II of the RAO and include [Source FCA List of financial activities we regulate, published 09/09/17]:

- advising on investments
- advising on pension transfers/opt outs
- advising on P2P (peer-to-peer) agreements
- dealing in investments as agent
- providing basic advice on stakeholder products
- managing investments
- safeguarding and administering investments
- effecting contracts of insurance
- carrying out contracts of insurance
- assisting in the administration and performance of a contract of insurance.

The above list is a sample only of a wide range of regulated activities. Home finance, consumer credit and other activities are also detailed in the FCA list.

Regulated activities cover specified investments, specified in Part III of RAO, including:

- deposits
- e-money
- rights under an insurance contract
- shares
- instruments creating or acknowledging indebtedness
- sukuk (sharia compliant debt instruments)
- government and public securities
- instruments giving entitlement to investments
- certificates representing some securities
- units in a collective investment scheme
- rights under a stakeholder pension scheme
- rights under a personal pension scheme
- options
- futures
- contracts for differences
- Lloyd's syndicate capacity and syndicate membership
- rights under funeral plan contracts, regulated mortgage contracts, home reversion plans, home purchase plans
- rights to or interests in anything that is a specified investment, excluding 'rights under regulated mortgage contracts', 'rights under regulated home reversion plans' and 'rights under regulated home purchase plans'

For smaller firms, the FCA has developed several standard permission profiles containing regulated activities and investment types. If these do not match the business that the firm wants to undertake, it will need to construct its own profile.

The activities and specified investment types regulated by the FCA are described in greater detail in chapter 2 of the Perimeter Guidance Manual (PERG), one of the Regulatory Guides issued by the FCA.

The FCA is also responsible for the registration of firms under the Money Laundering Regulations 2007 and Payment Services Directive, in addition to firms authorised by the FCA under the FSMA.

Business test

Under s22 of the FSMA, for an activity to be a regulated activity, it must be of a specified kind and carried on "by way of business". Whether or not an activity is carried on by way of business is ultimately a question of judgement that takes account of several factors (none of which is likely to be conclusive). These include the degree of continuity, the existence of a commercial element, the scale of the activity and the proportion that the activity bears to other activities carried on by the same person but which are not regulated. The nature of the particular regulated activity that is carried on will also be relevant to the factual analysis.

Exclusions

Activities that would otherwise be regulated activities can be turned into unregulated activities where an exclusion applies. If a firm can rely on an exclusion for an activity, it would not require FCA authorisation to carry it out. Such exclusions might include:

- Introducer exclusion
- Overseas Persons exclusion.

Exempt from authorisation

A person who is an appointed representative (AR) is exempt from authorisation. The AR acts as an agent for the principal. The principal must be a firm that is FCA authorised. The principal must accept full responsibility including any liabilities that might arise for ensuring that the AR complies with the FCA's regulation. There must be a written contract between the principal and the AR documenting this arrangement.

Professional firms (i.e. a firm of solicitors, accountants or actuaries) that are members of a designated professional body do not need FCA authorisation to carry on certain regulated activities that are incidental to its main business. Such firms are known as Exempt Professional Firms and are listed separately on the FCA Register. A professional body is designated by the Treasury under sections 326/7 of FSMA (Designation of professional bodies) for the purposes of Part XX of the Act (Provision of Financial Services by Members of the Professions). The following professional bodies have been designated:

on 28 March 2001

the Law Society of England & Wales the Law Society of Scotland

the Law Society of Northern Ireland

the Institute of Chartered Accountants in England and Wales the Institute of Chartered Accountants of Scotland

the Institute of Chartered Accountants in Ireland the Association of Chartered Certified Accountants the Institute of Actuaries.

on 14 January 2005,

the Council for Licensed Conveyancers on 10 February 2006,

the Royal Institution of Chartered Surveyors

Other bodies are exempt from authorisation and they include: the Bank of England, the European Central Bank, the central banks of EEA states, local authorities and various Government bodies.

4.2 APPROVED PERSONS AND CONTROLLED FUNCTIONS

An approved person is an individual who has been approved by the FCA to perform one or more "controlled functions" on behalf of an authorised firm.

The FCA may approve an individual only where it is satisfied that he is fit and proper to perform the controlled function(s) applied for. As presaged in the High Level Standards of the FCA Handbook, when considering the FIT test, the FCA looks at:

- (i) honesty, integrity and reputation (the FCA must be satisfied that the individual will be open and honest in his dealings and is able to comply with the requirements imposed on him)
- (ii) competence and capability (the individual must have the necessary skills to carry on the function he is to perform), and
- (iii) financial soundness.

Approval must be obtained before a person can perform a controlled function. Giving advice, and completion of the DRRA is a step towards this, is one of the controlled functions for which approval is required.

Controlled functions relate to the carrying on of regulated activities by a firm and these are authorised under s59 of the FSMA, by reference to the rules which are issued by the regulators.

Controlled Functions applicable to FCA solo regulated and dual regulated retail advisory firms are listed by the FCA as follows:

| | |
|---------------------------------|---|
| Significant influence functions | CF 1 Director function* CF 2 Non-executive director function* CF 3 Chief executive function* CF 4 Partner function* CF 5 Directors of an unincorporated association* CF 6 Small friendly society function* CF 10 Compliance oversight function CF 10A CASS Oversight Operation Function CF 11 Money laundering reporting function CF 12 Actuarial function* CF 12A With-profits actuary function* CF 12B Lloyd's Actuary function* CF 28 System and controls function* CF 29 Significant management function |
| Customer functions | CF 30 Customer function |

CF30 is the Controlled Function under which advisers generally operate

** denotes PRA Designated Controlled Functions applicable to dual regulated firms. The PRA leads the assessment of applications for approval in respect of these functions within each dual-regulated firm. However, the PRA requires the FCA's consent before approving an application for an individual to perform any PRA-designated Significant Influence Function.*

The FCA is solely responsible for all applications for approval for FCA Designated Controlled Functions (all of the above controlled functions) for all FCA solo regulated firms.

Where an individual is approved by the FCA to perform a controlled function, he has a number of responsibilities including a duty to be aware of and comply with FCA regulatory requirements and expectations. These include:

- continuing to comply with the FCA's Fit and Proper test for Approved Persons, which is set out in the FIT section of the FCA Handbook. Approved persons must report to the authorised firm and to the FCA any matter that may impact on their ongoing fitness and propriety
- complying with the Statements of Principle and the Code of Practice for Approved Persons, which is set out in the APER section of the FCA Handbook. The Statements of Principle describe the conduct that the FCA requires and expects of the individuals it approves. The Code of Practice sets out guidance, together with generic examples of conduct which does not comply with the Principles.

Where an approved person does not comply with these requirements this may result in the FCA taking enforcement action against him.

The FCA has the power to withdraw approval if it considers that an individual is no longer fit and proper. When deciding whether to withdraw approval, the FCA will take into account all relevant factors, including:

- the individual's qualifications, training and level of competence as required by the FCA's rules (considered in more detail in Part 2 of this Module, Regulation and Professional Standards)
- the honesty, integrity and reputation, competence and capability, and financial soundness of the approved person
- whether and to what extent the approved person has failed to comply with the Statements of Principle or has knowingly been involved in a contravention by the firm of a requirement imposed on it by or under the FSMA.

4.3 RECORD KEEPING REQUIREMENTS/REPORTS AND NOTIFICATIONS

Record Keeping

The standard periods of record keeping under section 9 of the Conduct of Business Sourcebook (COBS) rules require records to be kept for a minimum period. This differs according to the nature of the records to be kept:

- (1) if relating to a pension transfer, pension conversion, pension opt-out or FSAVC, indefinitely;
- (2) if relating to a life policy, personal pension scheme or stakeholder pension scheme, five years;
- (3) if relating to MiFID (or equivalent third country) business, five years;
- (4) in any other case, three years.

Reports and notifications

The FCA requires firms to provide (to the FCA) a wide range of information to enable it to meet its responsibilities for monitoring their compliance with requirements imposed by or under the FSMA. This starts immediately after initial registration. As the FCA say: "Once your firm has been authorised by us, you'll receive an authorisation pack. In the pack is a reporting schedule which tells you how to report and record information about your firm and its activities. We need to know how your management structure works and how you run your business. Once you're being regulated by us, you must supply us with information about your firm, so we can monitor your business. You need to be transparent and clear about how you record and report information to us. We need also need evidence to show that you've clearly communicated your firm's management responsibilities and structure to your staff."

Some of the required information is provided through regular reports (details of the requirements here can be found in SUP 16 of the FCA Handbook), while other information is collected under the requirement for firms to disclose appropriately to the FCA anything relating to them of which the FCA would reasonably expect notice (details can be found in SUP 15).

The FCA's guidance on what it would expect a firm to provide notification of, in an open and cooperative way, includes:

- generally it would expect to be told immediately of any matter that could have a serious regulatory impact, serious fraud or crime
- significant breaches of FCA rules and legislation, and a firm's insolvency
- when a firm is involved in civil, criminal or disciplinary proceedings
- matters relating to fraud, errors or other irregularities
- the firm is involved in insolvency, bankruptcy or winding up
- suspicious transactions (market abuse).

The regular reports required by the FCA include:

- details of shareholdings and the control of limited companies – control is broadly defined as shareholdings of at least 10%
- information about people and organisations with which the business has close links – e.g. subsidiaries or sister companies
- financial resources
- complaints received by the firm.

Most firms submit these reports electronically via GABRIEL (GATHERing Better Information ELelectronically), the FCA's online regulatory reporting system. Also ONA has been introduced as the FCA's system for submitting Online Notifications and Applications.

These reports help the FCA to monitor firms' compliance with the principles governing relationships between firms and their customers, requiring firms to maintain adequate financial resources, and with other requirements and standards under the regulatory system. Also by collecting this information on a regular basis the FCA can, over time, build up a picture of firms' circumstances and behaviour.

The FCA requires any firm with permission to effect or carry out life policies and/or to establish pension contracts to submit persistency and data reports. These reports allow the FSA to monitor firms both individually and collectively.

4.4 GIVING FINANCIAL ADVICE ON RETAIL INVESTMENTS

Regulated advice in the UK is currently defined under Article 53 of the current FSMA 2000 (Regulated Activities) Order 2001. HM Treasury may change this definition to differentiate advice, where an adviser has made a personal recommendation based on individual circumstances, from guidance, the need for the latter having developed as full advice has become more expensive.

With effect from 31 December 2012, the implementation of the Retail Distribution Review (RDR) rules has affected financial advisers working in retail investment. RDR is a key part of the FCA's consumer protection strategy. Its intention was to establish a resilient, effective and attractive retail investment market that consumers can have confidence in and trust at a time when they need more help and advice than ever with their retirement and investment planning. The aim of the RDR was to identify and address the root causes of problems that continue to emerge in the retail investment market. As the FSA said in the Overview to their June 2007 discussion paper (DP07/1), *A Review of Retail Distribution*: "the market for retail investments does not work efficiently – and certainly not as well as it could – serving neither the interests of consumers or firms, whether providers or distributors of retail financial services". The FCA has a number of objectives for the RDR, in particular:

- to maintain an industry that engages with consumers in a way that delivers more clarity for them on products and services
- to enhance a market which allows more consumers to have their needs and wants addressed
- remuneration arrangements that allow competitive forces to work in favour of consumers
- to maintain standards of professionalism that inspire consumer confidence and build trust
- an industry where firms are sufficiently viable to deliver on their longer-term commitments and where they treat their customers fairly
- to build regulatory framework that can support delivery of all of these aspirations and which does not inhibit future innovation where this benefits consumers.

The Financial Advice Market Review (see 3.2.1.) published its final report on 14 March 2016 and this builds on improvements brought about by the RDR.

Independent or Restricted Advice and Adviser Charging

Financial advisers working in the retail investment market need to describe the service they provide as either independent or restricted:

- to give independent advice, they need to offer clients a broad range of investment areas and products from all firms across the market
- to give restricted advice they can only offer clients certain products and product providers. Clients must be advised that such advisers are restricted.

Advisers should also:

- agree a fee upfront with clients and explain that financial advisers are no longer paid on commission
- hold a minimum qualification of QCF Level 4* and undertake 35 hours of continuous training (Continuing Professional Development) every year to keep knowledge up to date.

**the PMI's DRRA is an appropriate qualification for the RDR activity "Advising on Packaged Products" which includes pensions and retirement planning and it is also an appropriate qualification for the regulated activity "acting as a pension transfer specialist". It is a Level 6 qualification, which is equivalent to a Bachelor's degree. As such, any increase above the present Level 4 minimum - and that can be expected - is already covered.*

Professionalism

The FCA's Training and Competence (TC) Sourcebook sets out the requirements for having the skills, knowledge and expertise needed to discharge the responsibilities as an employee of a firm. This includes achieving a good standard of ethical behaviour.

The TC rules are designed to ensure that firms' employees are, and remain, competent for the work they do and that there is the appropriate level of supervision. As discussed in section 4.3 above, firms must keep appropriate records to demonstrate compliance with the TC rules including after an employee stops carrying on the activity. Here employees include self-employed representatives and appointed representative and their employees.

Following the RDR advisers need to display higher standards of professionalism and expertise. This requirement came into force on 31 December 2012. Advisers now need to adhere to enhanced professional standards and will need to:

- hold a Statement of Professional Standing (SPS) from an accredited body, such as the Pensions Management Institute
- hold an appropriate qualification (and for those advisers already practising on 31 December 2012 complete Gap Fill where required, Gap Fill being further structured and recorded learning to evidence that gaps in knowledge from when the qualification was first obtained)
- understand and observe the ethical requirements set out in APER, which they are subject to as an approved person
- expect the FCA and the accredited body issuing the SPS to hold them to account for these new requirements.

These professionalism requirements are considered in more detail in Part 2.

4.5 ANTI MONEY LAUNDERING AND PROCEEDS OF CRIME

Money laundering is a world-wide problem and the importance of tackling this is internationally recognised. An extract from the United Nations Annual Report for 2014 follows:

"Money-laundering

Money is the prime reason for engaging in almost any type of criminal activity. Criminal groups go to great length to conceal the source of their wealth, the location of their assets and the transfer of their illicitly generated funds. Governments are increasingly focusing attention on regulating their financial sector to combat this transfer of illicit funds in a fast moving, global market place. Money-laundering – which is estimated to amount to between two per cent and five per cent of global GDP* – poses a number of threats, including:

- *Fuelling corruption and organized crime*, with corrupt public officials, for example, needing to be able to launder bribes and kick-backs, and organized criminal groups having to launder the proceeds of drug trafficking and other crimes;
- *Facilitating terrorism*, such as where terrorist groups use money-laundering channels to get the cash needed to buy arms;

- *Damaging the reputation of banks*, which in turn can harm legitimate financial institutions; and
- *Harming the long-term prospects of developing countries*, given that 'dirty money' can have a serious impact on attracting the kind of solid long-term foreign direct investment that is based on stable conditions and good governance."

**given such huge figures - even 2% of world GDP is not far short of \$1,000bn – the interest of Governments world-wide is unsurprising. Missed tax revenues are not taken lightly.*

The FCA, given its international agenda and role, cannot but treat the matter very seriously.

But what precisely is money laundering? Money laundering is the process by which the proceeds of crime are converted into assets which appear to have a legitimate origin, so that they can be retained permanently, or recycled to fund further crime.

Three distinct stages in the money laundering process are recognised: Placement, Layering and Integration.

Placement involves transferring illegally obtained money into the financial system or into the retail economy. It is at this stage where the crime can perhaps best be detected and where vigilance is particularly valuable and expected of everyone involved in financial services. It is why identity is checked and why extra checks are sometimes required as considered later in this section. It is why the source of funds needs to be established.

Layering involves distancing the illegally obtained money from its source through a series of financial transactions, perhaps very complex, which makes it difficult to trace the origin. In financial services a suspicious transaction might involve the purchase of an investment fund, paying the appropriate advisory fee and then cancelling within a very short space of time without apparent good reason. Repurchase of another investment at the same time would deepen any suspicions which might arise. Layering makes use of legitimate financial mechanisms, including bank and building society accounts, currency exchanges, wire transmitting services, prepaid cards and investment vehicles, in attempts to disguise and distance the source of funds. Even casinos and other forms of gambling can be used. A shell company could also be set up. For that reason money laundering checks need to be made on corporate clients and the directors thereof.

Integration is the final stage of the process where the money launderer will convert the illicit funds into a legitimate asset. Integration may include the purchase of businesses, cars, property and conventional investment assets. Money laundering is very difficult to detect at this stage but if a new non-employed client appears with a lot of money to invest then the adviser would need to ask careful questions.

The principal UK statute in the fight against money laundering is the Proceeds of Crime Act 2002 (as supplemented by later Regulations). The Act created a number of criminal offences, including:

- to conceal, disguise, convert or transfer criminal property or remove it from the UK
- to be concerned with the arrangement to facilitate the acquisition, retention, use or control of criminal property
- to acquire, use, or possess criminal property.

It is also an offence to fail to disclose known or suspected cases of money laundering in the course of business in the regulated sector. This includes:

- deposit taking
- money changing
- dealing, arranging, advising on or managing investments
- arranging or advising on home finance
- arranging or advising on general insurance
- effecting or carrying out contracts of long-term insurance.

Disclosure must be made to the Serious Organised Crime Agency (SOCA) or the Money Laundering Reporting Officer (MLRO) of the business concerned. The MLRO is responsible for oversight of the firm's compliance with its anti-money laundering (AML) obligations and should act as a focal point for a firm's AML activity.

The Money Laundering Regulation 2007 took effect from 1 December 2007 and implements the requirements of the Third Money Laundering Directive. The FCA supervises the compliance of most financial services firms:

- it supervises the compliance of FSMA-authorised firms with the regulations. Mortgage brokers, general insurers and general insurance brokers are not subject to the regulations;
- it also supervises the compliance of certain other financial services firms. (This includes safety deposit box providers, leasing companies, share registrars, commercial lenders and e-money institutions. As recently as 1 April 2014 the FCA took over from the Office of Fair Trading the responsibility for supervising the AML procedures of Consumer Credit Institutions, which includes part of the activities conducted by pawnbrokers).

Guidance and interpretation on the regulations is provided by the Joint Money Laundering Steering Group (JMLSG), which is made up of the leading UK trade associations in the financial services industry. It aims to promote good practice in countering money laundering and to give practical assistance in interpreting the UK Money Laundering Regulations. This is primarily achieved by the publication of industry guidance.

A major revision of JMLSG's Guidance was published in January 2006. JMLSG subsequently amended its Guidance to reflect the provisions of Money Laundering Regulations 2007, which implemented the EU Third Money Laundering Directive in the UK. The Guidance was subject to further minor amendments in 2009 and 2011 following an internal review, and a new Part III to the Guidance was published in 2010. (The change in supervision affecting credit institutions will also be reflected in the JMSLG's Guidance.)

The assessment of money laundering risk should be at the core of a firm's AML effort and it is essential to the development of effective AML policies and procedures. Firms must put in place systems and controls to identify, assess, monitor and manage money laundering risk which are comprehensive and proportionate to the nature, scale and complexity of a firm's activities. Firms must regularly review their risk assessment to ensure it remains current. The FCA expects the senior management of a firm to take responsibility for its anti-money laundering measures.

Firms must also carry out customer due diligence (CDD). They must identify their customers and, where applicable, their beneficial owners, and then verify their identities and addresses. Different verification forms will be used for individuals as opposed to companies and non-UK persons are likely to require higher levels of CDD, perhaps significantly so for clients in higher-risk countries. In 2017, FATF has identified in their Public Statements two jurisdictions as high risk: the Democratic People's Republic of Korea and Iran, particularly the former. Identifying these jurisdictions encourages other member countries to take particular care with AML due diligence when dealing with clients in these named jurisdictions: MLROs will need to be mindful of the up-to-date position. Where appropriate other targeted financial sanctions in accordance with United Nations Security Council Resolutions will be taken. FATF closely monitors a handful of countries where they have particular concerns (Syria and Yemen for example) and works with other countries where necessary to identify and address those deficiencies which pose a risk to the international financial system. Further, it routinely and regularly reviews other countries' AML approach.

Firms must also understand the purpose and intended nature of the customer's relationship with the firm and collect information about the customer and, where relevant, the beneficial owner. This should be sufficient to obtain a complete picture of the risk associated with the business relationship and provide a meaningful basis for subsequent monitoring. CDD takes place at the start of the business relationship and when supplementary business is effected (unless AML has been performed in, say, the preceding 12 months). It is essential that AML is satisfactorily completed before the business is concluded.

In situations where the money laundering risk associated with the business relationship is increased – and this increased risk is discussed after the next few paragraphs – financial firms must carry out additional, enhanced due diligence (EDD). Where a firm cannot apply customer due diligence measures, including where a firm cannot be satisfied that it knows who the beneficial owner is, it must not enter into, or continue, the business relationship. Further if the adviser or any other employee of the advisory firm (or other firm) has any suspicions about identity or address or source of funds or any other activity which could raise suspicions of money laundering these suspicions must be reported to the firm's MLRO. The MLRO will then consider whether or not a report should be made to SOCA.

A firm must conduct ongoing monitoring of its business relationships on a risk-sensitive basis. Ongoing monitoring means scrutinising transactions to ensure that they are consistent with what the firm knows about the customer and taking steps to ensure that the firm's knowledge about the business relationship remains current. As part of this, firms must keep documents, data and information obtained in the CDD context (including information about the purpose and intended nature of the business relationship) up to date. It must apply CDD measures where it doubts the truth or adequacy of previously obtained documents, data or information.

The law requires that firms' anti-money laundering policies and procedures are sensitive to risks. Where the risk associated with the business relationship is increased, firms must carry out enhanced ongoing monitoring of the business relationship. This means that in higher-risk situations, firms must apply enhanced due diligence and ongoing monitoring. Situations that present a higher money laundering risk might include, but are not restricted to: customers linked to higher-risk countries or business sectors; or who have unnecessarily complex or opaque beneficial ownership structures; and transactions which are unusual, lack an obvious economic or lawful purpose, are complex or large or might lend themselves to anonymity.

The Money Laundering Regulations also set out three scenarios in which specific EDD measures have to be applied:

- **Non-face-to-face CDD:** this is where the customer has not been physically present for identification purposes, perhaps because business is conducted by telephone or on the internet.
- **Politically exposed persons (PEPs):** a PEP is a person entrusted with a prominent public function in a foreign state, an EU (including UK) institution or an international body; their immediate family members; and known close associates. A senior manager at an appropriate level of authority must approve the initiation of a business relationship with a PEP. This includes approving the continuance of a relationship with an existing customer who becomes a PEP after the relationship has begun. MiFID II (see 2.2 above) is strengthening the level of diligence required for PEPs.
- **Any other situation where there is higher risk of money laundering:** for example, where a correspondent bank is outside the EEA, the UK bank should thoroughly understand its correspondent's business, reputation, and the quality of its defences against money laundering and terrorist financing. Senior management must give approval to each new correspondent banking relationship.

The extent of enhanced due diligence measures that a firm undertakes can be determined on a risk-sensitive basis. The firm must be able to demonstrate that the extent of the enhanced due diligence measures it applies are commensurate with the money laundering and terrorist financing risks. For example, enhanced due diligence measures could include:

- obtaining details of the source of the customer's funds and the purpose of the transactions
- obtaining additional evidence of identity
- applying supplementary measures to verify or certify the documents supplied or requiring certification by a credit or financial institution
- ensuring that the first payment of the operations is carried out through an account opened in the customer's name with a credit institution.

Firms must apply EDD measures in situations that present a higher risk of money laundering and this should give them a greater understanding of the customer and their associated risk. It should provide more certainty that the customer and/or beneficial owner is who they say they are and that the purposes of the business relationship are legitimate; as well as increasing opportunities to identify and deal with concerns that they are not.

Firms must have a Money Laundering Reporting Officer (MLRO) who has a legal obligation to report any knowledge or suspicions of money laundering to the Serious Organised Crime Agency (SOCA) through a "Suspicious Activity Report", also known as a "SAR". Staff must report their concerns and may do so to the firm's MLRO, who must then consider whether a report to SOCA is necessary based on all the information at their disposal. Law enforcement agencies may seek information from the firm about a customer, often through the use of Production Orders.

Firms must keep copies of, or references to, the evidence of the customer's identity for five years after the business relationship ends; and transactional documents for five years from the completion of the transaction. Where a firm is relied on by others to do due diligence checks, it must keep its records of those checks for five years from the date it was relied on. Firms must keep records sufficient to demonstrate to the FCA that their CDD measures are appropriate in view of the risk of money laundering and terrorist financing.

Breaches of the AML requirements run the risk of personal financial sanction (or even imprisonment). Each advisory firm will have its own requirements and penalties in place and typically a serious money laundering breach could result in dismissal. But if the advisory or financial services firm does not have a robust anti-money laundering policy it too can be fined. On 26 November 2015, Barclays were fined £72 million by the FCA for poor handling of financial crime risks: they failed to follow their normal procedures so as to make matters easier for their very wealthy PEP clients. Deutsche Bank, Germany's biggest bank received a £163m penalty on 31 January 2017 from the FCA) and a \$425m fine from the New York State Department of Financial Services after it was found to have carried out suspicious transactions through its Moscow, London and New York offices that moved money from Russia to offshore bank accounts. Also in the global arena (bearing in mind introductory comments made in section 2.2), in 2012, the US Department of Justice imposed a record \$1.9bn fine on HSBC for its role in aiding money laundering by Mexican drug cartels, while HSBC Suisse was fined £27.8m (\$30.9m) by Swiss authorities on 4 June 2015, the largest fine in the country's history, for "organisational deficiencies" which enabled money laundering to take place. The Swiss authorities also fined Coutts 6.5m francs in February 2017 for breaching AML regulations while dealing with a scandal-tainted Malaysian wealth management firm. Even casinos have been fined: in September 2015, the US Financial Crimes Enforcement Network fined Caesars Palace in Las Vegas a total \$9.5 million for permitting wealthy clients to gamble in private rooms.

The principal money laundering offences are defined in sections 327, 328 and 329 of the Proceeds of Crime Act 2002:

- The offence under section 327 is concealing, disguising; converting or transferring criminal property, or removing criminal property from England and Wales.
- The section 328 offence potentially catches a large range of involvement in money laundering offences usually at the layering and integration stages, i.e. those who launder on behalf of others. It can catch persons who work in financial or credit institutions, accountants etc., who in the course of their work facilitate money laundering by or on behalf of other persons.
- The section 329 offence can be committed if a defendant uses or (passively) possesses criminal property.

A person convicted of an offence under these three sections is liable to imprisonment for 14 years or a fine or both.

Other offences arise under sections 330, 331 and 333 (s332 mirrors s331 but with regards nominated officers outside the regulated sector).

- Section 330 places a duty on employees in a business in the regulated sector (i.e. a sector that has a supervisory or other appropriate regulatory regime - such as financial advisers) to make reports where they “know or suspect” that another person is engaged in money laundering and where (even if they do not know or suspect) they “have reasonable grounds for knowing or suspecting” that a person is engaged in money laundering. The rationale for this is that a higher standard of diligence is expected in anti-money laundering prevention in the regulated sector, where comprehensive preventive systems (in line with international standards), are required to be in place. These include requirements to have in place internal systems for reporting and control, and education and training programmes.
- Section 331 creates a separate offence of failure to disclose in respect of nominated officers (i.e. compliance officers) who receive disclosures based under section 330 and who do not pass the information to the National Criminal Intelligence Service (NCIS) as the disclosure receiving agency when they know or suspect or have reasonable grounds for knowing or suspecting that another person is engaged in money laundering.
- Section 333 creates the offence of making a disclosure likely to prejudice a money laundering investigation being undertaken by law enforcement authorities, i.e. tipping off someone that an investigation could ensue.

All offences under sections 330-333 have a maximum penalty on indictment of 5 years’ imprisonment or a fine or both.

4.6 DATA PROTECTION

Without information, i.e. data, on clients, advice cannot be given. But the amount of data which can be collected and held needs to be controlled to protect the rights and privacy of individuals and to ensure that data about them are not processed without their knowledge and are processed with their consent wherever possible. Data protection legislation - the first Data Protection Act was enacted in 1984 - covers personal data relating to living individuals, and, further, defines a category of sensitive personal data which are subject to more stringent conditions on their processing than other personal data.

The Data Protection Act 1998 brought into effect the requirements of the EU Data Protection Directive (EU 95/46/EC). It replaced the Data Protection Act 1984, broadening its scope, and regulated the use of computers and other automatic processing equipment together with manual or paper records in a “relevant filing system”.

Section 1(1) of the 1998 Act defines “data” and “personal data” as follows:

“data means information which:

- (a) is being processed by means of equipment operating automatically in response to instructions given for that purpose,
- (b) is recorded with the intention that it should be processed by means of such equipment,
- (c) is recorded as part of a relevant filing system or with the intention that it should form part of a relevant filing system,
- (d) does not fall within paragraphs (a), (b) or (c) but forms part of an accessible record, or
- (e) is recorded information held by a public authority and does not fall within any of paragraphs (a) to (d).”

“*personal data* means data which relate to a living individual who can be identified:

- (a) from those data, or
- (b) from those data and other information which is in the possession of, or is likely to come into the possession of, the data controller, and includes any expression of opinion about the individual and any indication of the intentions of the data controller or any other person in respect of the individual.”

However, in the case of *Durant v Financial Services Authority* [2003] EWCA Civ 1746, the Court of Appeal took a narrow view of what constituted personal data. It took the phrase “relate to” to mean “concerning” the individual and said that whether information can be regarded as personal data depends on its relevance or proximity to the individual. To be personal data the information had to affect the privacy of the individual, whether in personal or business terms.

The 1998 Act also defines “data controller” and “data processor” as follows:

“data controller means ... a person who (either alone or jointly or in common with other persons) determines the purposes for which and the manner in which any personal data are, or are to be, processed.”

“data processor, in relation to personal data, means any person (other than an employee of the data controller) who processes the data on behalf of the data controller.”

The 1998 Act applies not only to computer held records, but also to paper-based files which are held in a “relevant filing system”. The Act defines this as follows:

“relevant filing system means any set of information relating to individuals to the extent that, although the information is not processed by means of equipment operating automatically in response to instructions given for that purpose, the set is structured, either by reference to individuals or by reference to criteria relating to individuals, in such a way that specific information relating to a particular individual is readily accessible.”

Organisations have to take appropriate measures to ensure that information, relating to individuals who can be identified from data, is adequately protected.

4.6.1 Data Protection Principles

The 1998 Act has eight data protection principles. These are broadly similar to those included in the 1984 Act. The eight principles are listed in Schedule 1 of the 1998 Act and are:

1. Personal data shall be processed fairly and lawfully and, in particular, shall not be processed unless:
 - (a) at least one of the conditions in Schedule 2 (see below) of the 1998 Act is met, and
 - (b) in the case of sensitive personal data, at least one of the conditions in Schedule 3 of the 1998 Act is also met.
2. Personal data shall be obtained only for one or more specified and lawful purposes and shall not be further processed in any manner incompatible with that purpose or those purposes.
3. Personal data shall be adequate, relevant and not excessive in relation to the purpose or purposes for which they are processed.
4. Personal data shall be accurate and, where necessary, kept up to date.
5. Personal data processed for any purpose or purposes shall not be kept for longer than is necessary for that purpose or those purposes.
6. Personal data shall be processed in accordance with the rights of data subjects (i.e. individuals) under this Act.
7. Appropriate technical and organisational measures shall be taken against unauthorised or unlawful processing of personal data and against accidental loss or destruction of, or damage to, personal data.
8. Personal data shall not be transferred to a country or territory outside the European Economic Area unless that country or territory ensures an adequate level of protection for the rights and freedoms of data subjects in relation to the processing of personal data.

Schedule 2 of the Act lists the following conditions that are relevant when processing any personal data:

- 1 the data subject has given his consent to the processing
- 2 processing is necessary for the performance of, or entering into, a contract to which the data subject is a party
- 3 processing is necessary for the data controller to comply with any legal obligation
- 4 processing is necessary in order to protect the vital interests of the data subject
- 5 processing is necessary for the exercise of any functions of a public nature exercised in the public interest
- 6 processing is necessary for the pursuit of legitimate interests by the data controller or by the third party or parties to whom the data are disclosed, except where such processing would prejudice the rights and freedoms or legitimate interests of the data subject.

When the data being processed is of a sensitive nature, e.g. relates to ethnic origins, religion, political beliefs, health and sexual life, strict conditions apply. These conditions are contained in Schedule 3 of the Act and usually require the data subject's explicit consent to the processing of the personal data.

Individuals have rights under the Data Protection Act 1998. These are designed to enable data subjects to obtain access to their personal records and to demand rectification of errors. Individuals have a right to:

- a copy of the personal data held on them
- object to processing that is likely to cause or is causing damage or distress
- prevent processing for direct marketing
- object to decisions being taken by automated means
- to have inaccurate personal data rectified, blocked, erased or destroyed in certain circumstances
- claim compensation for damages caused by a breach of the Act.

Data controllers may charge a maximum fee of £10 (for computer records) and £50 (for manual records) to any individual seeking access to records held on them (£2 if a credit reference agency) and have a maximum of 40 days to comply with the request.

The Data Protection Act 1998 requires anyone processing personal data to "notify" the Information Commissioner's Office (ICO). Notification is a statutory requirement to which every organisation must adhere unless they meet one of the specified exemptions* (such as a data controller maintaining records in the public interest or for judicial purposes). Notification is the process by which a data controller informs the ICO of certain details as to why they hold data. The ICO records this information on a register which is available for public inspection: ICO site on **www.ico.gov.uk**. Failure to notify is a criminal offence.

*The ICO's Data Protection Handbook states that processing personal information for personal, family, household and recreational purposes is also specifically exempted! While that might cause a wry smile, it does perhaps underline the otherwise far-reaching nature of the data protection legislation.

Financial advisory firms clearly need to notify the ICO of their data-processing activities. As data controllers, pension scheme trustees should also comply with the requirements and principles of the Act, which includes completing the notification procedure so that their details are added to the public register maintained by the Information Commissioner.

4.6.2 The General Data Protection Regulation (EU 2016/679)

On 25 May 2018, a major development in Data Protection came into effect. The General Data Protection Regulation significantly extends the requirements on businesses to protect the personal data and privacy of EU citizens for transactions that occur within EU member states. Its major features include:

- *Increased Territorial Scope* - applies to all companies processing the personal data of data subjects residing in the EU, regardless of the company's location.
- *Penalties* - under GDPR organizations in breach of GDPR can be fined up to 4% of annual global turnover or ?20 Million (whichever is greater).
- *Consent* - companies are no longer able to use long illegible terms and conditions full of legalese, as the request for consent must be given in an intelligible and easily accessible form, with the purpose for data processing attached to that consent. Consent must be clear and distinguishable from other matters and provided in an intelligible and easily accessible form, using clear and plain language. It must be as easy to withdraw consent as it is to give it.?
- *Breach Notification*- breach notification became mandatory in all member states where a data breach is likely to "result in a risk for the rights and freedoms of individuals". This must be done within 72 hours of first having become aware of the breach. Data processors will also be required to notify their customers, the controllers, "without undue delay" after first becoming aware of a data breach.
- *Right to Access* - the right for data subjects to obtain from the data controller confirmation as to whether or not personal data concerning them is being processed, where and for what purpose. Further, the controller shall provide a copy of the personal data, free of charge, in an electronic format.
- *Right to be Forgotten* (also known as Data Erasure) - the right to be forgotten entitles the data subject to have the data controller erase his/her personal data, cease further dissemination of the data, and potentially have third parties halt processing of the data.
- *Data Portability* - the right for a data subject to receive the personal data concerning them, which they have previously provided in a 'commonly use and machine readable format' and have the right to transmit that data to another controller.
- *Privacy by Design* - calls for the inclusion of data protection from the onset of the designing of systems, rather than an addition. It also calls for controllers to hold and process only the data absolutely necessary for the completion of its duties (data minimisation), as well as limiting the access to personal data to those needing to act out the processing.

The impact of this Regulation is extensive and advisers and advisory firms have had to review their systems, records and practices to avoid penalties. It will be challenging to find a way to meet the Right to be Forgotten requirement and yet at the same time ensure that evidence is retained to protect against a future complaint.

4.6.3 Data Security

There are a number of issues that firms should consider when reviewing their data security.

Firms need to identify what is included in client or customer data, that is any identifiable personal information about a customer or client held in any format, such as national insurance numbers, address, date of birth, family circumstances, bank details and medical records. This data is a high value commodity for fraudsters and retaining it securely is the responsibility of the firm.

Identifying the risks to this data will go a long way to making sure it is secure. The main areas to consider include:

- is the physical access to the premises secure, e.g. do you have a clear desk policy to reduce the risk of customer data being lost, stolen or being accessible to unauthorised persons and are filing cabinets locked when not in use

- do staff understand why data security is important and how to keep customer data safe; does this include any written policies or procedures covering data security
- are new staff vetted, i.e. are you confident that staff with access to large amounts of customer data are not susceptible to stealing data or committing fraud
- is customer data being disposed of in a secure fashion.

Many firms use third-party suppliers to carry out functions which could give them access to customer data, such as secure disposal, archiving, IT administration, office cleaning and security. It is good practice, therefore, to find out how third party suppliers vet their staff and have a good understanding of their security arrangements. This could be done by carrying out due diligence before hiring them.

Summary

This Chapter defined the principles and rules set out in the regulatory framework, and described the record keeping requirements place on advisers and how these need to meet the requirements of the Data Protection Act.

Self Test Questions

- What is a regulated activity?
- Define an approved person.
- What would the FCA expect a firm to report or provide notification of?
- What offences were created by the Proceeds of Crime Act 2002?
- When would enhanced due diligence measures apply?
- What are the eight Data Protection Principles?

PART 2

REGULATION AND PROFESSIONAL STANDARDS

OVERVIEW

Professional standards are regulated by the Financial Conduct Authority (FCA) and are an integral part of the FCA Handbook, a number of aspects of which were considered in the previous Part. To briefly revisit these aspects: on 1 April 2013, following the enactment of Section 1A of FSMA, the Financial Services Authority (FSA) was renamed as the Financial Conduct Authority (FCA). The FSA used both principles and outcomes-based regulation to establish its principles for business, corporate culture and leadership, and to establish the responsibilities for approved persons. The FCA has indicated that it will use forward-looking and judgement based regulation to make sure that regulatory outcomes improve, although there is much consistency in the areas concerned with professionalism. This forward-looking approach is echoed in the second paragraph of the Chairman's Foreword to the FCA's 2017/18 Business Plan: "A fundamental part of our Business Plan is the Risk Outlook. It identifies key trends in, and implications for the markets and firms we regulate, as well as the emerging risks we may need to respond to in the future."

Professional standards, which we consider in detail in this Part, have increasingly become part of the FCA's requirements. The FCA's overarching Code of Ethics is explained in this Part, as is the management of ethical dilemmas. We also describe the professional principles and values on which the Code is based. We then go on to distinguish between ethical and compliance-based outcomes. The FSA emphasised the importance of ethical behaviours and over a decade ago, they were very strongly encouraging advisers to put the customer first. Nowadays any failure to do this will probably result in a breach of TCF requirements leading to censure. This Part considers the evolution of as well as the basis of the FCA's current approach.

Finally in this Part we evaluate the importance of professional standards and judgement in establishing and maintaining client relationships, needs and priorities.

CHAPTER 1

The FCA's Use of Regulation

INTRODUCTION

As stated in the Overview to this Part, the FSA used both principles and outcomes-based regulation, while the FCA places more emphasis on forward-looking and judgement based regulation.

In this Chapter we look at how this approach is applied to the FCA's Principles for Businesses and how it affects corporate culture and leadership. This Chapter also describes the responsibilities of approved persons under the FCA's regulations.

1.1 PRINCIPLES FOR BUSINESSES

The FCA's Principles for Business are 11 general statements of the fundamental obligations of all authorised firms under the regulatory system; they are part of the High Level Standard's Block of the FCA Handbook, considered in the previous Part at 3.4.1. Authorised firms must comply with, and be ready, willing and organised to abide by the Principles at all times. Breaching the Principles may call into question whether an authorised firm still complies with the "fit and proper" Threshold Condition. Any breach is also likely to lead to disciplinary action by the FCA against the firm.

Firms, however, will not be subject to a Principle to the extent that it would be contrary to the UK's obligations under an EU instrument, e.g. there may be circumstances in which Principle 6 may be limited by the harmonised conduct of business obligations applied by the Payment Services Directive and Electronic Money Directive, effective from 2009 and introduced to increase efficiency in money transmission. (Section 1.9 in Part 1 considers the role of the Payment Systems Regulator.)

The Principles, which can be found in the Principles for Businesses (PRIN) section of the FCA Handbook, are:

| | |
|---|--|
| 1 Integrity | A firm must conduct its business with integrity. |
| 2 Skill, care and diligence | A firm must conduct its business with due skill, care and diligence. |
| 3 Management and control | A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. |
| 4 Financial prudence | A firm must maintain adequate financial resources. |
| 5 Market conduct | A firm must observe proper standards of market conduct. |
| 6 Customers' interests | A firm must pay due regard to the interests of its customers and treat them fairly. |
| 7 Communications with clients | A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading. |
| 8 Conflicts of interest | A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client. |
| 9 Customers: relationships | A firm must take reasonable care to ensure the suitability of its advice and of trust discretionary decisions for any customer who is entitled to rely upon its judgment. |
| 10 Clients' assets | A firm must arrange adequate protection for clients' assets when it is responsible for them. |
| 11 Relations with regulators | A firm must deal with its regulators in an open and cooperative way, and must disclose to the appropriate regulator appropriately anything relating to the firm of which that regulator would reasonably expect notice. ¹ |
| Note: The PRA applies Principles 1 to 4, 8 and 11 only. | |

As indicated in the footnote to the above table extract from the FCA Handbook, these Principles are also applied (in part) by the PRA. However the student does not need to be aware of the specific PRA requirements since these principally apply at the corporate level for banks and insurers.

1.2 CORPORATE CULTURE AND LEADERSHIP

In their Annual Report and Accounts 2016/17, Chapter 4, the FCA emphasize the importance of culture and governance. They have been focusing on the most significant drivers of good conduct or poor conduct which can lead to harm. They want to see individuals within firms embrace accountability for good conduct and the implementation of the Senior Managers and Certification Regime is central to promoting a culture of accountability. From 2018 the Senior Managers and Certification Regime will be extended to all FSMA-authorized firms.

Corporate culture has a significant impact on customer outcome and, therefore, became the key to the FCA's initiative on "Treating Customers Fairly". This initiative was originally developed by the FSA and remains central to the FCA's expectations of firms' conduct. In July 2007, the FSA identified key cultural drivers which were likely to have a significant influence on the behaviour of management and staff and on customer outcomes. These key drivers were published in their July 2007 paper Treating customers fairly – culture.

In practice, these drivers are nowadays incorporated into the six TCF consumer Outcomes which the FCA wants TCF to achieve for consumers. These were outlined in their July 2006 publication: *Treating customers fairly – towards fair outcomes for consumers* and remain core to what they expect of firms. The FCA continues to use them as important factors in guiding regulatory decisions and actions; the Outcomes will often be echoed in FCA publications. The Outcomes are:

- **Outcome 1:** Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- **Outcome 2:** Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- **Outcome 3:** Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- **Outcome 4:** Where consumers receive advice, the advice is suitable and takes account of their circumstances.
- **Outcome 5:** Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
- **Outcome 6:** Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

A firm's leadership sets its tone and the quality of its decisions. The FCA expects firms to be able to demonstrate that senior management has installed a culture within the firm whereby it:

- understands what the fair treatment of customers means
- expects its staff to achieve this at all times
- promptly identifies errors (where they occur), puts them right and learns from them.

These expectations of senior management have been underlined and enhanced by the requirements of the Financial Services (Banking Reform) Act 2013. This legislation was principally designed to overcome perceived shortcomings in the banking system and the FCA's remit has been strengthened with the inclusion of the Code of Conduct (COCON) rules in the High Level Standards Block of the FCA's Handbook (see section 3.4.1 in Part 1).

Controls, including management information, are essential to show how senior management measures and monitors performance and whether customers are being treated fairly when they interact with the firm.

The FCA is concentrating on corporate leadership and the customer-centric strategies the Senior Managers put in place. Perhaps this is a reflection of the FCA's wish to encourage a professional overall approach rather than to unnecessarily absorb time and effort by rigidly following the minutiae of detailed rules and regulations? In their 2017/18 Business Plan the FCA say: "Our focus continues to be on the most significant drivers of behaviour. These include senior management accountability and remuneration, and the steps firms and their senior managers take to address any risks caused by their behaviours. We are interested in the direction of travel of firms' cultures and whether indicators suggest that progress is being made. We will continue to support and drive cultural change across the industry."

Under the sub-heading of "Accountability and governance", the FCA continue "The key aims of the Senior Managers & Certification Regime (SM&CR) are to strengthen individual accountability at the most senior levels of relevant firms and improve their standards of conduct at all levels. We expect firms and their senior managers to apply the spirit, as well as the letter, of the regime.

To date, the SM&CR applies to deposit takers and dual-regulated investment firms. Firms already under the SM&CR have been undertaking fitness and propriety checks on all relevant individuals under the Certification Regime. Those firms currently in scope for the SM&CR are also expected to comply with the notification and training requirements to apply the conduct rules to all staff apart from ancillary staff. There is also a revised framework for insurers to raise standards of individual conduct, and additional rules that will apply more widely across financial services.

“In 2017/18, we will continue to embed the SM&CR in our supervisory approach and processes, and focus on how the SM&CR is integrated into the running of deposit takers and PRA-designated firms. Our authorisation work at the gateway also puts significant emphasis on the most senior individuals in firms, and we ensure our pre-approval processes are proportionate and dependent on the risks that the individual's role and the firm pose to our objectives.

“The SM&CR provides clarity for both firms and regulators about each senior manager's responsibilities. We will continue to use firms' responsibilities maps and individual senior managers' statements of responsibilities throughout the regulatory lifecycle. This includes when we approve and supervise individuals and firms and consider enforcement. These tools will further help us to identify and assess key senior individuals' management and governance arrangements.

“We will also use these tools with relevant firms as part of our proactive work with them, including to shape discussions about management and governance arrangements.

“We will also continue to develop our policy on designing and implementing an accountability regime for all FSMA firms, including further developing the regime for insurers. We will consult on the accountability regime for all FSMA firms in 2017 and complete our preparation to implement the regime from 2018.

“Our focus for the new accountability regime for all FSMA firms is to deliver a regime that is simple, proportionate and clear. We want the new regime to be simple and practicable for firms to understand and implement, and for the FCA to oversee and regulate. We plan to tailor the new regime to reflect the different risks, impact and complexity of firms. Across the industry, we want to be clear how the different components of the regime apply to different types of firms.”

Management Information (MI)

Management information is information or evidence that is collected during a period of business activity. Among other things, this may relate to activity or customer contact before, during or after the point of sale; service experiences; staff; trends and predictions. It is not just numbers, MI also includes commentary or opinions and these are important to provide a comprehensive, balanced view. All information relevant to a firm, from whatever source, can be described as MI.

Good MI should enable management to make good decisions. Therefore it should be:

- *Accurate* – the correct numbers with any commentary contributed by the right people.
- *Timely* – available quickly enough after the relevant business activity to enable managers to act.
- *Relevant* – displaying what a manager can directly influence or something that they may need to escalate to someone who can take the necessary action.
- *Consistent* – to allow managers to spot trends and make sound decisions.

MI may also be produced for, or requested by, management on a particular issue or concern on an ad hoc or infrequent basis. This is more cost effective if the investigation is a one-off event. Generally, however, firms should produce and monitor MI regularly to avoid problems rather than commission it in response to problems.

Firms should actively use MI to ensure that they are continuing to deliver fair treatment to customers. To do this effectively, it is important that there is robust governance and monitoring of the MI, which should demonstrate:

- commitment and accountability from senior management to identify and mitigate risks and issues affecting the fair treatment of customers and ensure that appropriate action is taken over any issues identified
- robust, appropriate MI and effective analysis that includes qualitative insights not just quantitative data, and
- processes in place to monitor the MI and to enable the right people to take action and to understand its impact.

The FCA expects firms to continuously seek to assess and improve their processes and practices, reviewing these regularly or when there is a change in the firm's structure, business practices and/or strategy. Bearing in mind the general comments just made with regard to MI, the management of advisory firms should ensure that their structure, ethos and controls are consistent with the SYSC requirements laid out in the FCA Handbook. These requirements were outlined in section 3.4.1 of Chapter 3, Part 1.

The detail of the SYSC section of the Handbook is substantial – as indeed is the detail of the Handbook as a whole. As an example of the type of detail included in the Handbook, extracts from SYSC are provided below. But these are also important in themselves since the manner in which financial advice is delivered to clients by advisers rests significantly with the way systems and controls are established by the employing firm. Corporate culture and leadership starts at the top!

(SYSC 1.2 Purpose) “The purposes of SYSC are:

- 1 to encourage firms' directors and senior managers to take appropriate practical responsibility for their firms' arrangements on matters likely to be of interest to the FCA because they impinge on the FCA's functions under the Act;
- 2 to increase certainty by amplifying Principle 3, under which a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems,
- 3 to encourage firms to vest responsibility for effective and responsible organisation in specific directors and senior managers; and
- 4 to create a common platform of organisational and systems and controls requirements for all firms.”

(SYSC 2.1 Apportionment of Responsibilities) “A firm must take reasonable care to maintain a clear and appropriate apportionment of significant responsibilities among its directors and senior managers ...”

(SYSC 3.1 Systems and Controls) “A firm must take reasonable care to establish and maintain such systems and controls as are appropriate to its business.

(SYSC 4.1 General Requirements) “A firm must 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, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems.”

1.3 APPROVED PERSONS AND PROFESSIONALISM

As well as its Principles for Business, which we have just considered, the FCA also has principles for approved persons, i.e. those carrying out controlled functions and, therefore, subject to individual registration. As with the Principles for Businesses, an approved person will not be subject to a Statement of Principle to the extent that it would be contrary to the UK's obligations under an EU directive. The Statements of Principle, from the Statements of Principle and Code of Practice for Approved Persons (APER) section of the FCA Handbook, are:

Statement of Principle 1

An approved person must act with integrity in carrying out his accountable functions.

Statement of Principle 2

An approved person must act with due skill, care and diligence in carrying out his accountable functions.

Statement of Principle 3

An approved person must observe proper standards of market conduct in carrying out his accountable functions.

Statement of Principle 4

An approved person must deal with the FCA, the PRA and other regulators in an open and cooperative way and must disclose appropriately any information of which the FCA or the PRA would reasonably expect notice.

Statement of Principle 5

An approved person performing an accountable significant-influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his accountable function is organised so that it can be controlled effectively.

Statement of Principle 6

An approved person performing an accountable significant-influence function must exercise due skill, care and diligence in managing the business of the firm for which he is responsible in his accountable function.

Statement of Principle 7

An approved person performing an accountable significant-influence function must take reasonable steps to ensure that the business of the firm for which he is responsible in his accountable function complies with the relevant requirements and standards of the regulatory system.

As well as complying with the Statements of Principle for Approved Persons, an approved person must be, and remain, fit and proper to perform their function. When considering a candidate's fitness and propriety, the FCA considers:

Honesty, integrity and reputation – the FCA bases its judgement on the individual's record in a number of areas including: criminal, civil or disciplinary proceedings, their employment record and past dealings with regulators.

Competence and capability – individuals have to show that they have met the relevant training and competence requirements for performing their control functions. They must also demonstrate that they are suitable for the role by their experience and training. The FCA will also have regard to whether the individual has adequate time to perform the controlled function and meet the responsibilities associated with that function.

Financial soundness – the FCA will look at both the current and past record of the individual with regard to debt, bankruptcy etc.

In practice, the responsibility of checking whether or not an adviser is fit and proper rests with his/her employer and specifically with the employer's Training, Competence and Compliance department(s), the precise format depending on the employer's size and structure. The FCA will not normally be involved other than to consider reports submitted by the employer. The employer will need to effect routine checks on all the above aspects obtaining declarations of assets and liabilities as well as the more obvious annual tests re professional competence.

The FCA will only become involved when something goes wrong. Then they can censure the individual. For example, in January 2014 a fine of £19,900 was imposed on one adviser for fabricating two Statements of Professional Standing giving the impression he was appropriately qualified. Another adviser was fined £662,700 in March 2014 for deliberately manipulating, on 10 October 2011, a UK government bond. A further example concerns a former successful fund manager who having admitted deliberately and knowingly failing to purchase a valid ticket to cover the entire journey whilst travelling on the South-eastern train service, the FCA considered (decision given on 15 December 2014) that the manager was not fit and proper to conduct any function in relation to any regulated activity because of a lack of honesty and integrity (note that his fraud was unconnected with any regulated activity and restitution to the train company had been made). More recently, in September 2017, a would-be compliance officer was banned because he failed to disclose two criminal convictions to his would-be employer. Fines, along with other action taken, are entered against the individual's name on the Financial Services Register which is public record. Those steps are now there to see for any student wishing to check: all four advisers are now "Banned". The student's goal is an "Active" status (or perhaps "Inactive" if you need a sabbatical!). Another way of looking at the punitive action which is taken by the FCA is to quote from their 2015/16 Report and Accounts, Chief Executive's Statement, which says: "in the past year we have continued to take tough action where required - imposing penalties of £884.6m on firms and individuals, banning 24 individuals and seeing jail sentences totalling 32 years and nine months' imprisonment handed down to individuals we have prosecuted.

In addition to the above requirements, an adviser needs to attain suitable qualifications, to undertake Continuing Professional Development, and to obtain accredited body membership, the latter making them more accountable for unethical behaviour. Advisers are required to meet and maintain these requirements if they wish to provide retail investment advice.

These changes aim to increase customers' trust in their advisers, who in turn will be more accountable for the advice they are giving. It also means that firms will benefit from having better quality advisers and the FCA can focus more easily on individual advisers where problems arise.

These standards are maintained and enforced by the FCA. Firms are required to submit data to them about their individual advisers. Accredited bodies will support advisers in attaining and maintaining these standards but must also inform the FCA of any advisers who are not meeting the standards required to obtain or renew a Statement of Professional Standing (SPS – considered below).

Accredited Body

Accredited bodies, listed in the Glossary to the FCA Handbook – and the Pensions Management Institute is listed as such – must meet criteria set by the FCA which are designed to deliver consistency in how advisers meet and comply with professional standards. At a high level, the criteria are:

- to act in the public interest and further the development of the profession
- to carry out effective verification services
- to have appropriate systems and controls in place and provide evidence to the FCA of continuing effectiveness
- to cooperate with the FCA on an ongoing basis.

To be accredited by the FCA, a body must meet these strict criteria and provide the FCA with regular independent audit reports of how they meet these criteria. These independent audits should cover areas such as how the body is raising professional standards, and key risks such as complaints handling. The FCA expects bodies which are accredited to play an important role in helping individual advisers attain and maintain their knowledge, carry out Continuing Professional Development (CPD) and behave ethically.

Accredited bodies must check that 100% of advisers who use their services hold an appropriate qualification, including any qualification Gap-Fill and CPD, where required. The accredited body will be able to rely on a previous confirmation from another accredited body that an appropriate qualification is held (this includes Gap-Fill and CPD).

Appropriate Qualification

The FCA has set its benchmark qualification level for all investment advisers at the equivalent of QCF Level 4, with relevant content built into the qualification.

The examination standards were put together following consultation which included consideration of how the core and specialist standards, and the content within them, should be best arranged. The final standards took account of feedback on those arrangements as well as the view that investment advisers are likely to need knowledge outside of their preferred areas of practice in order to understand whether their recommendations are suitable for their clients. (Established advisers at 31 December 2012 were able to augment old examination qualifications they held by undertaking Gap Fill activities to bring their qualifications up-to-date.)

The Training and Competence sourcebook includes Appropriate Qualification tables at appendix 4E. The list is comprehensive and shows which regulated activity a particular qualification granted by an awarding body permits.

Statement of Professional Standing

Advisers are required to obtain and hold an annual Statement of Professional Standing (SPS) as evidence that they are meeting the standards. The SPS will be issued by an accredited body and will contain:

- name
- name and contact details of the accredited body and a named signatory
- the end date of verification (maximum of 12 months from the date of verification)
- confirmation that the qualification(s) have been verified
- confirmation that the adviser has signed an annual declaration stating that he has kept his knowledge up-to-date and adheres to standards of ethical behaviour
- the adviser's individual reference number as it appears on the Financial Services Register
- a recommendation that the reader (e.g. a customer) should check that the adviser is on the Financial Services Register, and how to do this.

Accredited bodies must agree to certain conditions on how they will check that an adviser is achieving the required professional standards. But firms are still required to ensure that their advisers meet the FCA's training and competence requirements, specifically on qualifications, CPD and ethical behaviour.

Continuing Professional Development

The FCA requires advisers to complete a minimum of 35 hours of relevant CPD each year, with at least 21 hours of structured learning. The balance to 35 hours may be made up with "unstructured" learning. Structured learning activities may involve seminars, lectures, conferences, workshops or courses and completing appropriate e-learning. It is not carrying out research on products and services for customers. Unstructured learning could include reading professional publications or watching relevant webcasts.

CPD will be different for each adviser as it should ensure that he remains competent for the role he is undertaking and addresses any learning gaps in his technical knowledge. The FCA expects advisers to be able to demonstrate that they have learned and developed their knowledge and skills as a result of carrying out CPD activities. Typically this is achieved by the inclusion of a reflective statement against the CPD Activity.

Advisers will need to keep records of the CPD undertaken which should demonstrate how it has met their needs, e.g. knowledge gaps, what the learning target of the activity was and how this was achieved. The adviser's firm will be responsible for monitoring CPD and for ensuring that the adviser remains competent.

An annual declaration that the adviser has met the CPD requirements will be required by the appropriate accredited body, and the accredited body will carry out check of at least 10% of advisers to ensure they are meeting the minimum CPD requirements.

Ongoing complaints notification

The FCA requires firms to report complaints against their retail investment advisers to help them to understand individual retail investment advisers' behaviour and competence, to analyse trends and to intervene earlier.

Firms must submit to the FCA complaints notifications for their retail investment advisers within 20 working days:

- whenever three complaints are upheld relating to an individual investment adviser in any 12-month period or
- where a complaint is upheld and redress paid exceeds £50,000.

Details of these complaints must be submitted to the FCA electronically in a standard format prescribed by the FCA. After submission, they must also be reported via GABRIEL in the regular six-monthly return.

Complaints against individual retail investment advisers for activities which occurred before 1 December 2001 do not need to be reported.

Professional Standards Data

The FCA uses professional standards data to identify whether firms' retail investment advisers hold an appropriate qualification.

Firms must send to the FCA professional standards data for each of their retail investment advisers. After the first return, the FCA requires firms to submit the return as at the end of each subsequent quarter, unless there have been no changes to the information previously submitted. Firms must send this data within 20 business days of the end of the quarter. If there are no changes, they do not need to send a return. Firms must submit data reports to the FCA electronically in a standard format prescribed by the FCA.

Notification of Competence

From July 2011, all firms with retail investment advisers have been required to notify the FCA of competence and ethics issues that arise with those advisers.

Firms should notify the FCA as soon as reasonably practicable after it becomes aware, or has information which reasonably suggests that a retail investment adviser:

- is no longer considered competent;
- failed to attain an appropriate qualification within the prescribed time limit;
- failed to comply with a Statement of Principle (APER); or
- performed an activity without demonstrating competence and without supervision.

Some issues may be put right almost instantly by firms where there is no risk to consumers or where there is no suggestion of serious competence issues. For example, failing an internal assessment that was part of an ongoing training programme. In these circumstances there is no need to make a report.

The Retail Adviser Competence Notification Form approved by the FCA for notification may be found on the FCA's website and should be submitted to the FCA electronically.

1.4 THE FCA'S CODE OF ETHICS

As part of its requirements, the FCA has a code of ethics which advisers must follow, very similar to the Codes of Conduct of professional institutes. Indeed, pursuant to the Financial Services (Banking Reform) Act 2013, the FCA included the Code of Conduct (COCON) rules in the High Level Standards Block of their Handbook (see section 3.4.1 in Part 1). We will now look at the overarching code of ethics which has underpinned the approach of the FCA and its predecessors for many years.

This section describes the professional principles and values which make up the basis for this code. It then goes on to explain how advisers should manage ethical dilemmas.

1.4.1 Overarching Code

Ethics are generally defined as a set of principles or values of right conduct.

The FSMA and the FCA's principles and commitments embody a framework of core values which can be summarised as:

- open, honest, responsive and accountable
- committed to acting competently, responsibly and reliably
- relating to colleagues and customers fairly and with respect.

These are embodied in the FCA's Principles for Business and for approved persons, with the first Principle in each instance requiring that the firm or approved persons act with integrity. In addition, under training and competence in the FCA Handbook, the FCA defines competence as having the skills, knowledge and expertise needed to discharge the responsibilities of an employee's role. This includes achieving a good standard of ethical behaviour.

1.4.2 Basis of the Code

The standards of behaviour of firms and approved persons affect the FCA's ability to achieve its objectives set down by FSMA. Therefore the FCA seeks to maintain and improve these standards via principles-based regulation. These high-level standards are set out in the FCA Handbook, Code of Practices COCON and APER sections, with detail being added in the Conduct of Business Sourcebook (COBS) sections later in the Handbook

The FCA's values are embedded in its Principles for Businesses and Principles for Approved Persons (see 1.1 and 1.3 above). This code of ethics has developed over the years. Back in the 1980s this was evident in the tenets of "know your client" and "provide best advice". Section 119 of the FSMA clearly prescribed that the regulatory authority "must prepare and issue a code containing such provisions as the [regulatory authority] considers will give appropriate guidance to those determining whether or not behaviour amounts to market abuse" charging the FSA, the then regulatory authority, with the responsibility for preparing and issuing a code. In its discussion paper 18, *An Ethical Framework for Financial Services 2002*, the FSA argued that the "industry needs not simply to provide the necessary expertise, but to do so with integrity".

Some years later, as part of the Retail Distribution Review, the FSA considered ethical standards. The FSA believed that a consistent and more visible set of ethical standards was an essential element in improving consumer outcomes and changing their perceptions of the industry.

The FSA proposed (*Competence and Ethics Consultation Paper* CP10/12 published in June 2010) adding additional descriptions of behaviour to those already set out under Statements of Principle 1 and 2, as follows:

- paying due regard to the interests of a customer; and
- [not causing] deliberate acts, omissions or business practices that could be reasonably expected to cause consumer detriment.

The FSA chose these particular areas as it believed they emphasised personal accountability and how actions impact public perceptions. Following consultation, the FSA decided to go ahead with this proposal.

In January 2011, after extensive consultation, the FSA confirmed that retail investment advisers would need to hold a Statement of Professional Standing (SPS) if they wanted to give independent or restricted advice after January 2013 and that the SPS would provide customers with evidence that the adviser subscribed to a code of ethics, was qualified and had kept their knowledge up to date. These SPSs are issued by accredited bodies which would have their own code of ethics, consistent with the FSA's Handbook, APER rules, and would be able to play a role in creating adviser awareness and understanding of the ethical standards required. This would be of the same overarching ethical standard applicable to all approved persons.

The FCA maintains this approach so that where approved persons subject to the ethical requirements in APER also choose to be subject to a professional body code of conduct, it is unlikely that these codes will conflict. The FCA's accreditation criteria will require a body to ensure that its code does not contain any provisions that conflict with APER. This will give advisers certainty that, by subscribing to an accredited body, they are not subjecting themselves to contradictory regimes.

This does not preclude individual bodies from setting higher standards than APER in their own codes, but it does mean that all advisers will subscribe to the same common core standards.

Recently the FCA has introduced the Code of Conduct rules (COCON) following the Financial Services (Banking Reform) Act 2013. These apply to all senior persons within banks, building societies and credit unions, even if they do not give advice, as well as to persons giving advice in those firms. It can be readily seen that they tessellate closely with the underlying Code of Ethics;

Rule 1: You must act with integrity.

Rule 2: You must act with due skill, care and diligence.

Rule 3: You must be open and cooperative with the FCA, the PRA and other regulators. Rule 4: You must pay due regard to the interests of customers and treat them fairly.

Rule 5: You must observe proper standards of market conduct.

Treating Customers Fairly (TCF)

Under the overarching Code of Ethics, the FSA identified six customer outcomes that it wanted TCF to achieve for customers. These have been considered in section 1.2 above in our analysis of Corporate Culture and Leadership. Everyone involved in the provision of retail financial advice needs to be mindful of these Outcomes: they remain core to their expectation of firms and their employees and the FCA will continue to use them as an important factor in guiding regulatory decisions and actions. It is worth referring back to them at this juncture.

1.4.3 Managing Ethical Dilemmas

Many of the difficulties in the financial sector have centred on ethical issues, such as commission-driven mis-selling, lack of transparency, market manipulation, mortgage fraud and how to handle complaints.

In the past these issues were addressed by regulations which tended to focus on controlling processes rather than addressing the ethical issues underlying any problem. The FSA's discussion paper 18 An ethical framework for financial services, 2002 made suggestions which firms could use. With the FCA's move to judgement-based regulation, firms will need to ensure that they meet the FCA's core values in their day-to-day business.

1.5 ETHICAL COMPLIANCE-BASED OUTCOMES

This section outlines situations where care should be taken to behave in an ethical manner. It also points to some of the advantages which can accrue from ethical behaviours.

1.5.1 Behavioural Indicators

Unethical behaviour can arise for a number of different reasons. These might include:

- The pressure of short-term gain could be seen to encourage undesirable behaviour. Staff bonus payments may often seem to be geared to pure bottom line success. How risks and tensions can be identified is a constant issue – e.g. truth versus loyalty, one person versus the many. In all of this it is usual for the values and actions of senior management to influence employee levels.
- Some individuals behave unethically because they think it is worth the risk. This may be related to a short-term agenda, or may be simply personally selfish. People weigh up the pros and cons and take a chance. It is a deliberate risk/reward trade off.
- Others may believe they are behaving ethically but come to operate by a different yardstick to that used by others. They might do something which is deemed unethical, but which seems acceptable from their own perspective.
- Others (and some of these groups are not mutually exclusive) may be unaware of the values embedded in existing regulatory standards. So, they comply blindly with the “letter of the law”, rather than thinking about the wider effects their behaviour might have.

At the heart of the FCA's values is the outcome for customers. Under Treating Customers Fairly the first Outcome, i.e. customers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture, is key. Short term fixes, selfish actions and blindly taking action without knowing why, are all routes which could put the adviser and the employing firm in breach of FCA requirements: they should be avoided. To paraphrase a well-known quotation: “Ask not what your clients' assets can do for you, but ask what you can do for your clients' assets.” If the adviser succeeds in this he is likely to be behaving ethically, compliantly and profitably.

1.5.2 Outcomes from Behaving Ethically

Poor ethical standards clearly have detrimental effects. They pose risks to market confidence and consumer protection. They can increase the scope for financial crime and have a negative impact on public awareness and confidence. In contrast, the highest ethical standards can generate significant benefits for all stakeholders. Some of the potential benefits include:

Market Confidence – Differentiating the UK financial services sector as being renowned for good ethical practice, which could help it to absorb some “shocks”.

Consumer Protection – Improved ethical standards might include a better relationship between firms and consumers which would be reflected in, for example, improved financial promotions.

Financial Crime – By developing individual responsibility and a sense of involvement in all staff, a firm could reduce the likelihood of being targeted by criminals.

Public Awareness and Confidence – Higher business and individual standards of behaviour promoting the integrity and the general probity of all working in financial services will enhance public perceptions and trust in the firms and individuals concerned.

Summary

This Chapter has looked at how the FSA used both principles and outcomes-based regulation to establish its principles for business, corporate culture and leadership and to establish the responsibilities for approved persons and the shift in emphasis by the FCA to judgement based regulation.

The Chapter also discusses the FCA's overarching Code of Ethics which is based on its core values. It goes on to describe the professional principles and values on which the code is based, and how ethical dilemmas are managed.

It also considers the differences between ethical and compliance-based outcomes. It explained the outcomes that can arise from behaving ethically and how these outcomes differ if behaviour is limited to compliance.

Self Test Questions

- What are the FCA's Principles for Businesses?
- Describe the role of Management Information (MI).
- What are the FCA's Principles for approved persons?
- List the FCA's three core values.
- What information is contained in Professional Standards Data? When is submitted and to whom?
- What are the six customer Outcomes that the FCA wants TCF to achieve?

CHAPTER 2

Professional Standards and Advising Clients

INTRODUCTION

The application of professional standards and judgement is important in establishing and maintaining client relationships and in establishing a client's needs and priorities. In any client relationship there are a number of areas where professional standards and judgement are important. These areas include:

- establishing a relationship with the client
- gathering information
- analysing circumstances and requirements
- making recommendations
- effective communication of these recommendations
- monitoring recommendations and reviewing the client's circumstances and requirements.

The services which an adviser may be expected to include will involve the following:

- budgeting
- protection
- borrowing
- investment and savings
- later life planning
- estate planning
- tax planning and offshore considerations.

The points are inter-related and while the Client Service Agreement may emphasise certain facets or even exclude them, an adviser should normally expect to consider, analyse and make recommendations on all these aspects. Or explain if any particular facet does not fall within the advice being given. A quick example will help to clarify this: assume a client is seeking pension advice. A recommendation to a 40 year-old family man to make as high a pension contribution out of savings and income as possible could be poor advice if that client has a looming bill, loan repayment, large credit card debts and no life assurance cover in place. Quite simply, pension contributions are currently unaffordable: we examine this specific scenario elsewhere in the study material for the Diploma in Regulated Retirement Advice and consider the other services at appropriate junctures within the study material (some have already been discussed).

2.1 ESTABLISHING A RELATIONSHIP

When establishing a relationship with a client, a financial adviser should provide information which covers:

- the scope of the service being offered
- the adviser's qualifications and experience.

If there are areas, such as mortgages and pension transfers or opt-outs, in which the adviser does not have sufficient experience, when the adviser encounters such areas he should refer the client to an expert either inside the firm, if one is available, or outside the firm. The adviser can still work with the expert in delivering the overall recommendation to the client provided the advice is signed off by the expert where necessary.

This initial information should be in writing, although many advisers will take this opportunity to have a face-to-face meeting with the client to discuss and explain the information. The adviser should also provide a written document of the terms of engagement for the services to be provided. This document, a Client Agreement, should ensure that the client has a clear understanding of the work that the adviser is undertaking and what it will cost. It should set out:

- contracting parties and status
- the basis of the remuneration
- the services which will be provided
- the timescale in which the service will be provided, e.g. six-monthly or annual valuations
- the duration of the agreement, e.g. annual or permanent, with notice period provisions
- the frequency of meetings, e.g. at least once a year
- nature and timing of reviews
- confidentiality provisions
- any known conflicts of interest, e.g. between the firm or adviser and the client.

Financial advisers should make their status clear to clients before providing services. This includes telling clients whether they are restricted (the term “restricted” is now favoured post-RDR by the FCA rather than the former “tied”, “multi-tied” and “introducer” classifications), or independent with access to whole of market products. They should also make clear whether they offer basic or full advice. If a recommendation does not meet the standard for independent advice then it is restricted advice. Restricted advice can be restricted because of product availability limitations and/or because of limited access to providers. Independent advice should satisfy the requirements of COBS 6.2. Briefly, for a recommendation to be regarded as independent, advice needs to be:

- (a) based on a comprehensive and fair analysis of a sufficient range of relevant products;
- (b) unbiased and unrestricted.

This was reiterated in the FCA's March 2014 Thematic Review TR14/5: Supervising retail investment advice: Delivering independent advice and it is expected that the FCA will re-confirm the position when MiFID II is operative in January 2018.

Basic advice was introduced in April 2005 and aims to increase access to financial products by offering consumers a low cost way to receive advice on and purchase a limited range of products. Where advisers are offering basic advice they should explain it is a short, simple form of financial advice which uses pre-scripted questions to identify a client's financial priorities and decide whether a product from the range of low-cost regulated saving and investment stakeholder products is suitable for the client. Basic advice falls under the definition of “restricted advice” in the FCA Handbook Glossary.

If no advice is being given i.e. information only, then this should also be made clear. The FCA's website under types of investment adviser allows for this “guidance” service.

Advisers may be an “appointed representative” (s 39(2) of FSMA). An appointed representative (AR) is a person who, or firm which, conducts regulated activities and acts as an agent for a firm directly authorised by the FCA. The directly authorised firm is known as the AR's “principal”. There must be a written contract between the principal and the AR documenting the arrangement. The principal takes full responsibility for ensuring that the AR complies with FCA rules. Typically an AR will be a member of a network.

The underlying rule is that a firm giving advice to a retail (private) client must have enough personal and financial information about them to be able to ensure that any recommendation made is suitable for the client. This is the “assessing suitability” requirement, or “know your customer” rule, and this is looked at in more detail in 2.2.1 below.

Where a client is unwilling to disclose information the financial adviser needs to decide how to deal with the situation. There are several scenarios to consider.

One option is to treat the client as an execution-only client. In this situation no advice must be given, the financial adviser's role is simply to provide information and to carry out the client's wishes. The position should be fully recorded, including written confirmation from the client in his own words. If the adviser feels that it is possible to give advice despite the non-disclosure the client should confirm in writing that he has not disclosed the information requested and is aware that this may influence the advice given. Some firms are reluctant to offer execution-only business because the FCA, if it finds a significant amount of execution-only business (on a specific visit to a firm), may query why so much business is being done by a firm which holds itself out to provide independent financial advice. Execution-only should be the exception not the rule.

Where a client only wants advice in a limited area, the financial adviser should make the client aware of the limited nature of the advice given and this should be recorded in the suitability report.

A client may wish to make an investment or embark on a course of action that is not suitable for them. Given this situation, the adviser should provide the client with written advice that this is not a suitable investment in the client's circumstances, pointing out what the disadvantages are and that they should only carry out the transaction if the client insists: the insistent client scenario. Here it is particularly important that the client confirms his requirements in his own words and in writing. The adviser should be mindful of the requirements set out in COBS 9.4 regarding suitability reports which must, at least:

1. specify the client's demands and needs;
2. explain why the firm has concluded that the recommended transaction is suitable for the client having regard to the information provided by the client; and
3. explain any possible disadvantages of the transaction for the client.

Such a report would for example explain why a client needs his pension fund to buy a pension because he needs income in retirement or in a different scenario the other options should be adequately assessed. If the client has an overriding demand to encash his pension to pay off a debt, then at least the adviser will have done his job. If the client still wants to access his pension fund for that specified reason, i.e. pay off a debt, the suitability report should say that. NB: to say blandly that "the client wants to encash his pension early" is not likely to be acceptable to the FCA as an adequate reason.

Whatever the scenario, the FCA expects the adviser to ask for information and request full information. In other words the suitability report should be personalised and constructed around personal data. Even in a limited advice scenario, if a complaint arose the adviser would have difficulty in retrospect in justifying why he, say, put a client into a specialist equity investment which lost money giving rise to the complaint when the client had substantial debts which are now even more problematic, given the loss of capital. If the client in that situation was hoping for a quick gain and was experienced enough and sufficiently prepared to take a considered risk, and if all of that background was evidenced both on the fact find and in the suitability report, then the adviser should have sufficient defence against future complaints and therefore should be able to transact the business.

Alternatively the financial adviser could decide not to act for the client.

Professional clients

A very small number of clients can be treated as "professional clients" rather than retail clients. These are likely to be people such as professional investors who prefer not to receive all the risk warnings or to go through the full suitability assessment process. The advantage is that the costs and time involved in providing risk warnings and documenting them can be omitted, but the drawback for the client is that he loses much of the protection that ordinary clients have if they have bought an investment they did not fully understand.

Fuller details are included in COBS 3.5 but briefly clients can choose to be treated as professional clients for some or all of their investments if:

- they have been warned about the protection that they will lose and have been given enough time to consider the issues
- they have agreed in writing
- the firm has good reason to believe that they are expert because of their investment history as well as knowledge and understanding.

Institutions such as insurance companies, collective investment schemes and investment firms are per se professional clients.

2.2 GATHERING INFORMATION

Before a firm gives a customer a financial recommendation it must take reasonable steps to find out and record sufficient details about the customer that relate to the services it is offering. The financial adviser should ask the client about their personal details, employment status, relationships, financial position both with regard to income/expenditure and assets/liabilities, public and private benefits, insurance & assurance policies and entitlements (e.g. pensions), immediate needs and short- and long-term goals. This will usually be done through a combination of fact finding forms, correspondence, telephone conversations and customer meetings. This process is also referred to as “know your customer”. It is important to have evidence of this information gathering and it is customary for all details to be recorded on the personal information analysis/fact find signed by both adviser and client - or clients if advising couples.

2.2.1 Fact Finding

The FCA Handbook (COBS 9) stipulates that before a personal recommendation is given the “necessary information” about the client must be obtained: i.e. fact finding. Fact finding is the process of gathering information about the client and the main headings on most fact-finds relate to questions that a financial adviser might need to ask relevant to the personal recommendation he is to make for the client. At the end of the process the financial adviser should have a summary of the client’s financial position which can be used in the objectives setting process. Bear in mind that the FCA have moved on from the earlier regulatory position where rules were the basis of regulation. Now the FCA is interested in outcomes and the best interests of the client are paramount. Each client is unique. It is not simply a process of asking a number of set questions: it may also be necessary to ask supplementary questions that are more probing.

If the client does not wish to divulge certain information then that decision to withhold information should be recorded, preferably in the client’s own handwriting, on a signed fact-find. That withholding of information should be referred to in the suitability report and the consequences pointed out i.e. that advice might have been different had more information had been provided.

Below we look at the key areas that need to be covered in the initial fact finding form which is completed, very probably at the initial customer meeting. The format will differ from advisory firm to advisory firm but the target content needs to be comprehensive in all cases (though if limited advice is demonstrably being provided, certain sections can perhaps be omitted ... with care and with careful explanation in the suitability letter). Note also that from Autumn 2017 the FCA has confirmed that it will be acceptable for fact find data to be transferred from one adviser to another, with the client’s connect of course because of data protection considerations; this process is known as “porting”.

A fact-find might take the following format:

Part 1: Client details

| | Client | Partner |
|-----------------------------|--------|---------|
| Name | | |
| Date of birth | | |
| Relationship status | | |
| National Insurance number | | |
| UK resident? | | |
| Home address | | |
| Home telephone number | | |
| Mobile number | | |
| Email address | | |
| Preferred method of contact | | |

Part 2: Objectives: tick where applicable and also indicate priority

| | Client | Partner |
|--|--------|---------|
| Investment (and any specific purposes) | | |
| Mortgage repayment | | |
| School Fees | | |
| Pensions | | |
| Protection for family and self on sickness | | |
| Protection for family and self on Critical Illness | | |
| Medical Expenses insurance | | |
| Long Term Care Planning | | |
| Inheritance Tax Planning | | |
| Will | | |

Part 3: Children and other dependants (partner/elderly dependants etc.)

Do you have any dependants?

| Name | Date of birth | Relationship | Financially dependant | Sex |
|------|---------------|--------------|-----------------------|-----|
| | | | | |
| | | | | |
| | | | | |
| | | | | |

Part 4: Employment status and income

| | Client | Partner |
|------------------------------------|--------|---------|
| Main occupation and job title | | |
| Secondary occupation and job title | | |
| Income from main occupation | | |
| Income from secondary occupation | | |
| Other benefits | | |
| Other income (e.g. pensions) | | |

Part 5: Expenditure

| | |
|---|---|
| Home related expenses – including mortgage, utilities, council tax, property insurances, etc. | £ |
| Household expenses – including food, clothing, newspapers, broadband, cable TV, etc. | |
| Travel costs – including running a car, fares | |
| Medical – including dentists, opticians | |
| Childcare | |
| Leisure and entertainment | |
| Life and health insurance | |
| Other | |
| Total | |

| Part 6: Assets and Liabilities | | |
|---|---------|----------|
| | Client* | Partner* |
| Main Home | | |
| Second home | | |
| Home Contents | | |
| Cars | | |
| Cash | | |
| Gilts | | |
| Other Fixed Interest Stock | | |
| ISAs Cash/Help to Buy | | |
| ISAs Stocks and shares/peer-to-peer | | |
| LISAs | | |
| Insurance Bonds | | |
| Equities | | |
| OEICS/Unit Trusts | | |
| Business Assets | | |
| Endowment Policies | | |
| Term/protection insurance | | |
| Whole of Life Policies | | |
| Total | | |
| Mortgage | | |
| Credit Card balances (if not paid off each month) | | |
| Business loans | | |
| Other Loans | | |
| Total | | |

* Indicate if joint

| Part 7: Pensions Benefits including benefits already taken or encashed | | |
|--|--------|----------------|
| | Amount | Insurer/Scheme |
| Defined benefit contracts Estimated pension £pa at Normal Retirement Date | | |
| | | |
| | | |
| Defined Contribution contracts: Current Fund | | |
| | | |
| | | |
| Estimated State Pension Benefits | | |

Part 8: Attitude to Investment Risk

Your answers will indicate how you feel at present about risk and potential loss. Please read the following profiles and select which profile closely matches your current thinking. Our advisers may re-assess your risk profile from time to time. Please speak to your adviser directly, should you feel that your profile has changed.

Very Cautious

You wish to take no risk to the nominal value of your capital. You understand returns may change but may be small and might not match inflation. Investments are likely to be cash and fully protected products.

Cautious

There is a small risk to your capital. The aim is to achieve longer term growth in excess of inflation through a small exposure to equities in mature markets or similar financial products. Income has the potential to be marginally higher than fixed term deposits but is variable. Investments are primarily cash, gilts and fixed interest with a small exposure to equities. You can potentially suffer limited losses.

Balanced

This offers longer term growth to capital but with no guarantees, risk is controlled through a diversified portfolio (in the main mature equity markets and bonds/fixed interest with limited property and overseas exposure). There is potential for loss although exposure to bonds reduces this risk. Income can be variable.

Dynamic

Risk to capital is approximately in line with the UK equity all share index but with diversification through a number of asset classes (equities, including overseas, plus small weighting in bonds/fixed interest and property). Values can rise and fall so an investor may not get back the full amount invested.

Adventurous

You are prepared to invest predominantly in equity based investments (UK and overseas) and may invest in some specialist funds with potential for higher returns while accepting increased risk to your capital.

Speculative

In addition to a diversified UK and overseas equity portfolio, you are prepared to invest a significant part of your portfolio in a range of specialist asset classes with the aim of potentially much higher returns but with a potentially increased risk to some or all of your capital.

Please indicate the overall Investment Risk Profile:

| Client | Very Cautious | Cautious | Balanced | Dynamic | Adventurous | Speculative |
|----------------|---------------|----------|----------|---------|-------------|-------------|
| Spouse/Partner | Very Cautious | Cautious | Balanced | Dynamic | Adventurous | Speculative |

The above represents basic customer information. Other key areas include:

- details of expected inheritances
- health details.

The template given above is not prescriptive. Each advisory firm will have its own fact find, tailored to its business, and quite probably that will run into many more pages with spaces for comments and supplementary information. Factfind templates change in the light of experience and in response to FCA requirements. Fact finds will continue to evolve. When they were first required in the 1980s, a factfind might have been little more than notes on plain A4 or perhaps details added to a pre-prepared two-page A4 pro-forma. Two dozen pages now are not unusual. It might even be electronic where an answer to one question could produce a specific set of further queries. A positive reply to the existence of Defined Contribution pensions benefits might trigger separate queries on retirement annuity contracts, personal pensions, SIPPs, contribution history, investments, Lifetime and Annual Allowance usage, existence of Transitional Protection and so on. An IHT planning objective could trigger queries on previous gifts so the adviser can assess whether Chargeable Lifetime Transfers have occurred or when a Potentially Exempt Transfer falls out of future IHT computations.

2.2.2 Customer Meetings

The initial customer meeting will be an important tool for establishing a relationship with the customer where they are comfortable to speak freely about their personal circumstances and what they want to achieve. The fact find can be completed or if already started the financial adviser and the client can go through the fact finding to fill in any gaps in the information and to provide further detail. It is also an opportunity for the financial adviser to get letters of authorisation signed by the client so that he can obtain detailed information about the client's investments, protection policies or other financial circumstances from providers and other advisers.

A possible agenda for the initial customer meeting could include:

- the purpose of meeting and the possible benefit to customer
- what the customer can expect from the adviser (including details of the adviser's costs and services)
- details of the client's goals, values, interests
- a detailed breakdown of income/expenditure and assets/liabilities
- information regarding the customer's attitude to risk and investment philosophy
- information on the financial planning process that the adviser will undertake
- information regarding the fact that other advisers may be used where appropriate
- setting a date for the next meeting.

Using the information provided by the client in the fact finding form, the financial adviser can use the meeting to ask supplementary questions. It is essential to ask additional or supplementary questions when a client provides important information. The key is knowing when additional information is required and the implications of possible different answers: the next section considers this in more detail.

2.2.3 Supplementary Questions and Rationale for Basic Questions

The supplementary questions that an adviser will need to ask will vary depending on the advice being given and the client's basic circumstances. Below we look at some of the key areas.

Name and address – for anti money laundering reasons the adviser must confirm the identity of the client. This can be done by asking the client for proof of identity such as a passport or driving licence, together with a recent utility bill. More recently this requirement has been met by electronic checks (made back at the office) for which the client gives permission (by signature on the Client Agreement) and only if there are warnings from the electronic process (which do arise for completely innocent reasons, for example: recent change of address, errors in source information of the electronic means used) does further evidence need to be obtained. If a client is known to be a Politically Exposed Person (see Part 1, Chapter 4), then it may be simpler to take documentary evidence of name and identity at outset rather than come back to the client at a later date when prompted by electronic anti-money laundering checks. The need to have evidence that the identity/address aspect has been checked, in the absence of electronic checking systems, means that photocopies, black and white not colour because of the perceived risk of forgery using those colour copies, will need to be obtained. This could cause problems if the client does not wish to release important documentation: for example giving up possession of their passport to take out life assurance because they are going abroad! So careful advance planning would be needed. Electronic anti-money laundering checks can be much easier! Establishing whether a client is normally resident or domiciled in the UK or outside of the UK can also have considerable tax implications and, therefore, can have a major impact on many aspects of financial planning. A partner of a client could have a different domicile or even residence.

Age, health and lifestyle – knowing a client's age, any health issues (see also next paragraph), whether they smoke, and whether they take part in dangerous sports or travel frequently is important when looking at insurance and can affect the cost of providing products such as life cover and medical insurance. The availability of enhanced and impaired life annuities means that aspects such as Body Mass Index (which medical underwriters calculate from height and weight information) and medication are also very relevant. If an adviser is perhaps considering an impaired life annuity, then details of medication would need to be obtained (or perhaps warn the client that further information will be desirable and why)

Power of Attorney – the fact find should also include details of any general Power of Attorney, Lasting Power of Attorney or Enduring Power of Attorney (the latter will have been signed before October 2007), including the names of the nominated Attorneys (which could include a Court-appointed guardian) and the circumstances in which the Attorney acts. A Power of Attorney can be of two main types: Health and Welfare and/or Property and Financial Affairs. Where a Power of Attorney exists it is also important for the adviser to establish what authority the Attorney has: does it extend to permitting discretionary investment management? The Power of Attorney would very likely subsist because the assets of a vulnerable client are being managed, and then the adviser would need to pay special attention to that vulnerable client's best interests. If not, then application to the Court of Protection would be needed. [Powers of Attorney are considered in more detail in Part 4 of this Manual.]

Vulnerable Clients - Where an adviser is dealing with a vulnerable client – and this does not necessarily mean a client for whom a Power of Attorney is in place – the FCA require extra care to be taken in the advice process. The FCA describe a vulnerable client as “someone who, due to their special circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care”. A vulnerable client could be someone who is over the age of 80 or someone with impaired sight or vision. The adviser needs to “know his client”.

Relationship/marital status – knowing whether a client is married, in a civil partnership, divorced, or in a relationship has implications for issues such as responsibilities for children, Inheritance Tax, Capital Gains Tax and survivor's benefits under pension schemes. Also where there has been a divorce or separation there might be maintenance payments to be made and outstanding claims on properties or pensions. These aspects can significantly affect client objectives and whether the financial product recommended is suitable, including whether or not it is affordable.

Children – children have a major effect on financial planning, so it is important to know their ages, state of health and plans for the future. This might include tactfully asking young couples if they (are planning to) have children and older couples if they (are expecting to) have grandchildren. Where a couple or a single person has children, a substantial amount of their expenditure will be devoted to the child or children either directly or indirectly. It is important to establish whether any funds for the upkeep of children are provided from sources other than the parents' income, e.g. a trust fund of which the child is a beneficiary. Education plans should also be taken into account: are the children going to attend private schools; do they want to plan for children going to university. There are also implications if clients should die, so a financial adviser should establish whether clients have made suitable arrangements in this area, such as writing a Will and nominating guardians for children in case they both die.

Protection policies – information should be gathered concerning any policies already in place, including: lives assured, sums/benefits insured/assured, premiums (and who pays for them particularly where there are employer-related benefits), start dates and end dates and any review periods/dates. This will enable the financial adviser to see what options are available to the client, what the value of any existing policies is including premiums which might have been based on the client's age many years earlier and whether there are any gaps in their protection cover.

Financial dependence – it is important to know who is or might become financially dependent on a client. Children will be financially dependent on parents, but various other people might be or become dependent and it would be prudent to find out who they are: e.g. elderly parents, adult children or relatives who suffer bereavement, serious illness or become disabled and need financial support, relatives who are not fully capable of looking after themselves. The financial adviser should aim to understand the circumstances and quantify the degree of financial dependence and its likely duration. Financial inter-dependence is also relevant in the fact-finding process.

Income and employment – the fact find should establish the client's income from employment and other sources. The financial adviser might also consider establishing whether there is any risk of redundancy and if so how easy it would be for the client to find another job. He should also consider what other benefits are provided by an employer, e.g. company car, medical or dental insurance and employee share option schemes. The marginal tax rate of the client should be apparent from income returns but it is worth checking in case there are specific adjustments which apply to High Net Worth clients in particular. Is there any Gift Aid?

Tax status – Income Tax and a client's marginal rate of tax is an obvious consideration just mentioned. But a client's Capital Gains Tax position, where investments may need to be sold, and his potential Inheritance Tax position, allowing for previous and planned gifts, need also to be considered.

Expenditure – understanding a client's needs and aspirations involves establishing current levels of expenditure. It is worth using a detailed expenditure analysis, maybe taking details from bank statements and possibly credit card statements, but some clients may be reluctant to provide detailed information. In such cases it is important to have at least the total income and expenditure. Once this has been established it may be possible to identify areas of expenditure which are fixed, e.g. mortgages and utility bills, and areas that are discretionary, e.g. leisure and entertainment. By doing this it might be possible to identify areas in which a client could reduce expenditure if they decide they want to increase their level of saving or to make some other financial provision. Assessing expenditure is very important. If expenditure exceeds income and there is little spare capital, then is the product being recommended affordable? If not, then a recommendation, for example, to an income-poor widow to take out a whole of life policy to cover Inheritance Tax on the large family property she still occupies is not going to be regarded as good advice.

Assets – key information includes:

- ownership of asset
- whether or not an asset is used, e.g. property
- when the asset was acquired
- why the asset is being held
- what is the income and tax position, including CGT
- what is the inheritance tax status of the asset
- what investments do they have – single premium investment bonds, with profits products etc.

Liabilities – it is important to have details of any loans and mortgages. This should include the type of loan, interest rate, repayment level, term and any security given. This may also include taking into account any pending income tax liabilities where, for example, a client is self-employed or where a PAYE taxpayer has property income.

Pension details – where a client has built up pension provision or is a member of a pension scheme the financial adviser should ensure that he has details of the benefits that will be provided at retirement and the type of scheme that these are being provided through, i.e. defined benefit or defined contribution. Unless the client is very young, it is likely that clients will have at least one pension contract and this probability will become almost certain for all clients over 22 who have worked when automatic enrolment is fully in place by 2018. Once this information has been gathered it will be possible to discuss with the client their target pension benefits, try to make up any shortfall and make use of the tax benefits likely to arise from paying additional contributions into a pension arrangement.

N.B. Pension contracts are considered in more detail in Part 5 of this study manual and in the Taxation, Retail Investment and Pensions study manual.

Attitude to Investment Risk – the FCA Handbook comments that “a transaction may be unsuitable for a client because of the risks of the designated investments involved, the type of transaction, the characteristics of the order or the frequency of the trading”. In other words suitability requirements mean that the customer’s appetite for investment risk needs to be understood. How that is done is left to the adviser and the adviser’s employer. The adviser’s employer is involved in this since pre-determined investment profiles are likely to exist, both in gauging a client’s risk appetite and in providing an investment solution. The table in Part 8 of the factfind above is only one of a possible range of Attitudes to Investment Risk. Attitude to Risk tables have changed over the years and still differ between advisers. There may be a shorter Attitude to Risk list: one insurer, now subsumed into a larger group, used to offer Safety, Opportunity and Adventurous funds to reflect Cautious, Balanced and Adventurous Attitudes to Investment Risk. Some advisers or providers in trying to match their funds to consumer needs may use five, seven or even ten+ risk classifications. What is important is the approach the client has to risk and if the client wishes to say with reference to the above table that he is somewhere between Balanced and Dynamic or that he is Balanced but does not want any Fixed Interest, then so be it. The adviser’s job is then to find (if he can – and if he cannot he should say so) investments to match the client’s requirements. In considering Attitude to Investment Risk, remember that a husband and wife could have different Attitudes: challenging for joint investments and if necessary the requirements of each would need to be dealt with separately. Also a client may have a split Attitude to Risk depending on the reason for investments: Cautious, with regard to pensions perhaps particularly if he is close to retirement; but Adventurous with capital (perhaps over a certain level) which he regards as “fun money”. It does happen! Someone with a defined benefit pension, either as an expectation or in payment, perhaps from the Services, may on the other hand be Cautious with the capital he has for investment but Adventurous with regard to the top-up personal pension he wants to set up from his new job following retirement from his Services career. That also happens. The rationale of the advice process is to find out what the client wants AND what the client needs. These two aspects are not necessarily the same and they need to be covered off in the suitability report. Whatever Attitude to Risk table is used, it needs to be used as the tool it is and applied appropriately in understanding the client’s Attitude to Investment Risk. Attitude to Risk is covered in more detail in Part 3 of this study manual.

Capacity for loss goes hand in hand with Attitude to Investment Risk. The FSA in their Assessing Suitability, March 2011, Guidance commented “although most advisers and investment managers consider a customer’s attitude to risk when assessing suitability, many fail to take appropriate account of their capacity for loss”. They defined this as a 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. The comment some dozen or so lines earlier about taking into account a client being close to retirement is a good example of how capacity for loss can modify an otherwise clearly stated Attitude to Investment Risk.

Overview: The financial adviser and his employer must maintain the confidentiality of the information provided by the customer. These records must be kept for a minimum period as set by the FCA and also in a way consistent with the requirements of the Data Protection Act. [Refer back to Part 1, Chapter 4, of this study manual for more detail here if you wish.]

2.3 OBJECTIVES

Once the adviser has gathered information from the customer regarding their financial position and what they hope to achieve from financial planning, the adviser will need to analyse the circumstances of the customer and see how best to achieve their requirements. This process may require a number of meetings before the adviser and customer can establish and finalise a plan of action.

This will enable the adviser to produce a clear evaluation of the current strengths and vulnerabilities of the customer's financial circumstances. These are then compared to the customer's goals, plans, limitations and tolerance to risk. The objectives should be clear and agreed with the client. Some advisers may choose to be guided by the acronym SMART – i.e. Specific, Measurable, Action related, Realistic, Time related.

Establishing a client's needs and objectives can be achieved by questioning or by asking them to select from a list of possible aims and objectives (as in the specimen fact find suggested in section 2.2.1 above) and to rank the selections in order of importance. Where questions are used, it is important that these should be thought provoking. For example if a client is asked if they want to be financially independent the answer is likely to be yes, but if he is asked what financial independence means to him the answer is likely to be more meaningful, e.g. paying off credit cards and having sufficient pension provision to be able to retire at a chosen age. The adviser should take care to establish clear objectives and not be tempted to “paper over” an objective in an attempt to tick a box. It won't satisfy the FCA! It won't satisfy your Compliance function! It won't even satisfy the client if the client has second thoughts a couple of years after the advice was originally given and lodges a complaint.

A good example of establishing clear needs is an insistent client wanting “to encash his pension early”: that “reason” is merely “papering over”. What if that pension is important in maintaining his standard of living? On the other hand obtaining £60,000 under pensions freedom to pay off an expensive debt is a clear objective which can be allowed for in properly delivered advice.

However, a client's aims and objectives should not be taken at face value (the “wants” and “needs” juxtaposition referred to in Attitude to Investment Risk above is relevant) as some may be unrealistic (e.g. excessive investment growth), some may be mutually incompatible (high investment growth with low risk) and, as already presaged in the fact-finding section above, there may be conflicts between the aims of one spouse and the other. If there are irreconcilable differences they must be made clear to a client. A good example of this is the 35-year-old client who wants to retire on an aggregate pension equal to three-quarters of his salary. If that client is divorced, starting a second family, has a large mortgage, perhaps a second mortgage, a car loan and credit card debt (but hopefully no pay-day loans), as desirable as a “75%” pension is, it is highly unlikely that regular contributions to support such a pension expectation will be affordable, for some time at least. The advice to that client will be pay off the credit card debt and car loan, concentrate on reducing the mortgage and take out, say, £20 worth a month in protection policies. Perhaps not very remunerative initially for the adviser (though as the industry moves to fees maybe the playing field even here will level out) but if that 35-year old is still a client in 15 years' time, the potential for wider advice then, and even for the children of his first relationship as well, is high. For the present, the threat of a complaint could hardly arise IF the correct advice is given– and that is very important to the adviser as well as the client.

Once objectives have been identified, they can be split into immediate objectives and future objectives. Clients tend to emphasise immediate objectives, such as meeting immediate expenditure needs or obtaining a mortgage to buy a home, and this often means that future objectives, such as building up sufficient retirement income, are sacrificed. It is essential that needs are prioritised. Financial advisers are well aware of the importance of long-term or contingent needs, such as pensions, life assurance or income protection, which require clients to reduce immediate expenditure. Discussion between the financial adviser and the client will typically involve prioritisation of objectives and reconciling what the client wants with what the financial adviser considers the client needs.

Where clients express objectives in qualitative statements, e.g. "I want to retire on an adequate income", it is important to equate this to quantitative statements, e.g. "I want to retire on an income that is not less than 75% of my pre-retirement income". In this way it is easier to set out how objectives can be attained ... and if they can!

So to recap, once the client and financial adviser have identified a range of aims and objectives these need to be prioritised. Some will be more urgent than others, e.g. paying off credit card debt, but most people have the same broad hierarchy of needs:

- covering the day-to-day living expenses
- protection against the unexpected
- buying a home and raising a mortgage
- paying for children's education
- saving for retirement
- savings and investments
- estate planning.

The most basic aim is to have enough income to cover the essential expenses of food, accommodation, heating, etc. building in a buffer for emergency cash. After this, protection against the potential financial impact of death or illness could be a priority for clients who depend on their earnings, but this might not be a priority for a client with substantial assets. Saving for retirement might be a priority for many working people, but for other clients saving to purchase a home could be of more importance. For retired clients, maximising income and minimising the potential impact of Inheritance Tax on their estate could be the top priorities. Priorities change over time as people's circumstances change (consider our hypothetical 35-year old). Therefore, prioritising objectives is a process that needs to be revisited over the years. Even during the planning process it may be necessary to change the priorities as the plan develops and as the client's knowledge is increased through careful questioning.

Once the adviser has fully analysed the customer's circumstances and requirements, he can develop a financial plan for the customer. Before the final recommendations are made the adviser and customer should review the proposed plan. This would include discussing and resolving with the client any issues regarding the understanding of the customer's:

- circumstances
- goals
- tolerance for financial risk
- tax position.

The adviser should then provide the customer with a written plan which includes suitable and usable financial recommendations. The written plan takes the form of a Suitability Letter or Suitability Report.

2.4 SUITABILITY LETTER

In section 2.1 above, part of COBS 9.4 was quoted. It is worth repeating: suitability reports must at least:

1. specify the client's demands and needs
2. explain why the firm has concluded that the recommended transaction is suitable for the client having regard to the information provided by the client; and
3. explain any possible disadvantages of the transaction for the client.

When preparing to make a recommendation to a customer, an adviser should:

- ensure that he has captured all the relevant “know your customer” information before making any recommendations
- recommend a product, fund or service to match the customer's circumstances and attitude to risk
- allow for the use of existing contracts the customer may have and not surrender or cancel any contract or investment without fully considering the implications
- recommend the most appropriate product and provider (unless a tied agent or where restricted advice is being provided) where the limitations of advice need to have been spelt out at outset) and explain the decisions to the customer
- explain the different options which have been considered and explain why they are not as suitable as the chosen course
- consider affordability, debt repayment, the impact on benefits and tax implications as part of any recommendation.

An adviser must also ensure that he or his employer has conducted adequate research, including on products considered and recommended to meet client objectives, and retained sufficient evidence of that research to support the recommendation.

Nearly all clients, if we are considering pensions advice, are looking for broadly the same outcomes regardless of their aims and objectives. These are:

- to maximise income and funds/other accruals in the accumulation stage
- to retain flexibility of access to their funds
- to keep costs down
- to minimise tax where possible
- to minimise risk, consistent with Attitude to Risk.

There are always disadvantages as well as advantages to any recommendations and clients need to understand these disadvantages. The Suitability Letter should spell out both. We will return to the Suitability Letter/Report preparation later in this Chapter: its preparation draws on the principles set out above and on further fact find aspects considered in the following sections.

2.4.1 Cash Flow

The statement of income and expenditure is often the starting point for any planning as this helps to identify whether there is a surplus or deficit of income over expenditure. Where there is a surplus the question is how to best use this surplus, but in many cases there will be either a break-even position or a deficit. In these cases the financial adviser needs to help, or at least encourage, the client to either change his income or to change his expenditure, or a combination of the two. Often, the identification during the fact-finding process of the client's need is enough for the client himself to realise that something needs to be done. The solution might involve suggesting if the client is able to increase working hours or level of pay and looking at the client's discretionary expenditure, e.g. on things such as leisure activities, to see if these can be cut back. Where clients habitually borrow to fund current expenditure, they should usually be encouraged to follow a strategy of cutting back expenditure. Obviously there are limits to the efficacy of the financial adviser's advice: clients will make up their own mind. But that must not stop the adviser from making measured recommendations and sounding caveats. Remember that the client's interests come first and the Suitability Report will need to evidence that those interests were allowed for at outset.

Example

If a client has a need for protection for his family but has an expensive hobby which eats away at spare income, the Suitability Letter should allow for that: perhaps the wording would be along the lines of: "We agreed that you need £250,000 of life assurance cover for 15 years to protect your family. However we established that on your present level of expenditure this was not affordable. Normally I would not recommend any financial products when the premium is not affordable but we further agreed that the need for protection for your family is pressing since you are self-employed and we further agreed that you could spend £x a month on life assurance protection benefits by making savings from spending £x less on your hobby and take advantage of rates at your current age and in your present good health." The wording may seem common sense, or intrusive, or patronising depending on the student's own viewpoint. But it establishes the need, considers affordability, disadvantages, present circumstances and possible future events. Different sets of circumstances will apply in every advice situation but if each advice situation goes through the basic points (and that brief wording above does not and cannot pretend to cover all situations - though the full content of this Chapter gets much closer), then there is a credible defence against the possibility of a future complaint, when that same client has had an accident/illness or suffers a decline in business and claims that if he had been advised properly about the increasing cost of insurance and that he could easily have spent less on his hobby if that had been pointed out.

Many of those studying for the DRRA are perhaps unlikely to come across a personal advice scenario. But if you are giving advice on a pension transfer to a client who has other needs then you need to ensure that the client realises that those other needs are not being considered. There the wording of the Suitability Report would make it clear that advice is only being given on a specific pensions transfer. And care would be needed on the affordability issue if any advice was given to the above individual to pay additional pension contributions.

Clients should also be encouraged to aim to have some easily accessible cash resources. This cash buffer can be used to fund specific purchases such as holidays, cars and other consumer durables rather than using loans or credit cards. It can also be used in emergencies such as breakdown of "white goods", short-time working, short-term sickness including of family members and even in the early stages following redundancy. From this, the financial adviser should have a reasonably clear idea of whether a client can afford to take on a commitment. There are certain types of commitment that should not be taken on unless the client can afford to continue them under normal circumstances, including:

- any investment into an equity-based or other volatile investment where the client is likely to need access to the funds in the near future, when the value may have fallen
- any life or health protection policy where the client is unlikely to be able to maintain the premiums for a reasonable proportion of the term
- a pension scheme if the client is likely to need access to the funds in the short term
- any pension or savings plan where there are early termination penalties. Although the front-end loading which gives rise to such penalties should infrequently be met with (check older contracts carefully), following RDR and the FCA's steps to remove commission and up-front charging. Nonetheless there will be agreed fees. Here an adviser needs be certain that a client will not raise a complaint about an "unnecessary" fee: this should not happen where fees are agreed but if the client became dissatisfied after receiving advice, his complaint could cover any aspect of the advice process.

After retirement, the need for a client to keep income and expenditure in balance is usually greater because there is less scope to boost income from earnings. This has been particularly the case following the fall in interest rates and coupon return from Fixed Interest stock from March 2009 when the Bank of England lowered its lending rate to 0.5%. Retired clients may also need help with drawdown contracts and in using pension funds wisely especially after the March 2014 Budget announcement which introduced "Pensions Freedom".

2.4.2 Debt

There are many different types of loan and methods of repayment. Recommendations for dealing with them should be to:

- pay off high-cost debt, e.g. credit cards, as quickly as possible. More recently pay-day loans have proliferated. These, with Annual Percentage Rates significantly exceeding 1000% (one well-advertised company topped 5000% in mid-2013) make even standard credit cards interest rates of 25% (typically) look reasonable. Helping clients (or perhaps their family members) to understand the nature of such loans is invaluable though debt management per se rarely falls within the remit of an IFA
- retain flexibility over repayment as far as possible
- consider flexible/offset mortgages for self-employed people or those with irregular income or expenditure patterns. They could then consider making either large irregular payments to reduce the mortgage or deposits to offset the interest costs
- regard fixed interest loans as a way to budget for future expenditure or insure against future increases in the interest rate
- choose a loan repayment arrangement that corresponds with the client's attitude to risk.

2.4.3 Financial Planning Protection

The main types of financial planning protection that should be considered are life assurance, income protection insurance, critical illness insurance and private medical insurance. As longevity improves, but not necessarily good health, long-term care planning is also emerging as an advice area.

Life assurance cover should be based on assessed need rather than a rule of thumb calculation such as ten times annual income or even the much-loved four times salary which emanated from the pre-2006 HMRC maximum for lump sum payments. Rule of thumb could leave some clients with too little cover and others with too much: how could that be explained and justified in the Suitability Letter? It could not, so first establish whether there is a need for life assurance cover, i.e. is there anyone who would suffer if the client dies. If there are no dependants there is probably no need for cover (unless a young single person who plans to marry and raise a family wishes to take out a renewable - and perhaps convertible - term policy while in good health). Once a need has been established the next step is to quantify the amount of capital (e.g. to cover outstanding liabilities) and income (e.g. for a surviving spouse) that will be required and to determine how long each element of the insurance cover will be required. (It may be that a lump sum is more tax-efficient since an income will probably be taxable.) Some needs may be relatively short term, e.g. to provide for children until they leave home, while others might be needed until retirement. Others could cover Inheritance Tax either on a whole life basis or short term basis to protect against tax arising on Potentially Exempt Transfers.

Once this has been established, the financial adviser should take into account whether existing policies, pension schemes or other assets can be used to offset the need for cover. Finally the adviser should recommend the appropriate types of policy, taking account of costs. If the cost of providing total cover is considered too high, it might be necessary to prioritise cover.

Income Protection, also known as Permanent Health Insurance (PHI), and Critical Illness insurance can be considered as complementary. They pay out in different ways and possibly in different circumstances, but should be approached and analysed in a similar way to life assurance cover. There is a case for having both types of protection in place.

PHI provides an income for as long as the policyholder is unable to work (within the policy definition). It pays out, after a waiting period (specified in the policy conditions) for injury and illness. The policy definition of disability needs to be carefully chosen. Will payment be made if the insured cannot work in his own occupation or if he cannot work at all? The former cover is more expensive. The policy definition of "work" may also vary over time, for example: "own employment" at the point of claim, changing to "any employment" after the claim

has been in payment for a set period such as 12 months. Payment of PHI benefits depends on submission of medical evidence to the claims underwriter at the insurance company providing the benefits. Levels of benefits are generally lower than a person's previous earnings; this is to reduce "moral hazard" where a claimant might decide (to try) not to go back to work if his PHI benefit is higher than his prior income.

Critical Illness insurance pays out on diagnosis of a Critical Illness event defined in the policy document, such as a non-fatal heart attack where the insured is still alive after 28 days. This is different from life assurance where a fatal heart attack would trigger immediate payment. Critical Illness benefits are not usually linked to earnings (though they could be on group policies). The lump sum from a Critical Illness insurance policy could be used to help in a client's recovery, to relieve them of debt, such as a mortgage, or to finance short-term needs such as home improvements to accommodate a wheelchair or buy a specially adapted car. It could also be used to fund a pension.

Private medical insurance (or Medical Expenses insurance) may be a priority for some clients. This might be the case where a client runs his own business and needs control over when to receive medical treatment. The costs of Medical Expenses insurance can vary considerably and savings can be made in the extent or type of coverage. The adviser should also ensure that this is not already provided by the client's employer since the client may be able to benefit from economies of scale by using the employer's policy. Limited versions of Medical Expenses insurance are available either by selecting certain limited options (e.g. excluding hospital outpatient cover; selecting limited dental or optical treatment insurance or none at all).

Long term care insurance is very difficult to obtain. A few insurers a decade or so ago did offer cover but the steeply escalating costs of care home fees have made this cover extremely difficult and expensive to obtain. Nonetheless, despite the lack of readily available competitive insurance cover, long term care planning remains a need and specialist financial advisers with specific accreditation will use an investment portfolio coupled with pensions and annuity income, possibly an enhanced impaired life annuity, to create sufficient income to defray home care costs. We considered the availability of State help in the Taxation, Retail Investment and Pensions manual, Part 4, Chapter 2.8, and this adds significant complications particularly as the Government has different and frequently-changing approaches to this need. Long-term care remains a specialist planning issue.

2.4.4 Redundancy

Clients should aim to have enough to live on for at least a few months if they lose their job. What "a few months" means will depend on the client's circumstances and what he feels the out-of-work period could be (a soft-ware expert may be out of work for little more than a few days; a miner may never work again, at least in that role): again it revolves round careful discussion with the client and knowing that client's circumstances. Post-redundancy income will arise from State benefits, savings and possibly redundancy insurance. Clients should not rely on state benefits because Job Seeker's Allowance (JSA) is usually very substantially less than what they would have been earning, part is means-tested and the basic amount is paid for up to six months only provided clear evidence of seeking work can be given. After that, the means-tested Employment Support Allowance is the only benefit available.

There are several possible strategies to consider:

- building up an emergency reserve
- taking out insurance to pay the mortgage
- taking out a flexible mortgage which will allow a borrower to suspend or reduce mortgage payments for a period
- keep any redundancy lump sum safe and accessible so that it can be drawn on as sparingly as possible.

Longer term, the client will need to be flexible with regard to alternative work. Financial planning to provide for redundancy as well as other objectives needs to be considered against wider priorities.

2.4.5 Savings and Investment

Clients may want to build up a lump sum over a longer period by setting aside money on a regular basis or as it becomes available for investment. The longer the timescale, the more chance there is that the return from an equity investment will be positive. Equity fund managers will produce statistics to show, for example that in any 18-year period there is a 99% probability that Equities will have outperformed against other forms of investment. The statistics may be contrived but it is true that equities do perform well over the longer periods. Nevertheless if money is likely to be required over a set period of time, e.g. in less than ten years, then an equity investment is relatively risky. The adviser will need to assess the appropriate level of risk of the investment and recommend investments accordingly, allowing for the client's Attitude to Investment Risk.

By the stage of making recommendations the client and adviser should have agreed an outline investment policy statement, and allowed for protection policies where needed. The investment policy statement should set out:

- the purpose of the investments
- the income and growth objectives
- the timescale
- a statement about the client's risk profile, either in detail or outline
- a statement about asset allocation, either in detail or outline
- other issues such as ethical or socially responsible investments: the latter are sometimes referred to as "ESG" investments where the letters stand for Environmental, Social and Governance.

The policy statement may well evolve as issues become clearer and it will certainly change over time as the client's circumstances develop and the investment and financial environment changes.

2.4.6 Suitability Report: Recent FCA Guidance and Structure of Report

Once an adviser has reached the stage of making recommendations, this needs to be communicated to the customer. As stated earlier in this Chapter, this is achieved with a Suitability Report/Letter.

In preparing a Suitability Report, the adviser should consider whether the report [*Source FCA Factsheet 23, published September 2014*]:

- is tailored to your customer (Note: it has since been reiterated by the FCA that it is important to focus on the client here and ensure that the recommendation is personalised i.e. the suitability report should not be a collection of standard paragraphs which are largely irrelevant to the client's current requirements)
- uses clear and plain language;
- explains the reasons for all recommendations and how they relate to the customer's objectives
- highlights the risks associated with the recommendations
- explains the costs, charges and potential penalties attached to the recommendations
- provides a balanced view
- highlights if you have omitted any objectives
- highlights how the customer will be advantaged or disadvantaged by the advice and
- shows evidence of comparisons on a like-to-like basis where an existing plan has been cancelled and a new one devised.

The FCA have provided the following commentary and examples of good practice [*Source FCA Factsheet 23, published September 2014*]:

When preparing and issuing suitability reports, remember that customers are less likely to consider the recommendations being made if the report is too long. Instead, you could put technical information in an appendix.

Here are some other good practices we have seen. Firms:

- Gave a clear summary of the customer's objectives, needs, priorities and relevant existing investments, demonstrating the adviser had taken account of these.
- Used bold text to highlight key risks and changes associated with the recommendations.
- Used the customer's own words taken from file notes, to make the recommendations more relevant.
- Sent reports to customers before the second meeting and fully discussed at the meeting.
- Used bullets instead of long sentences.

Good and poor practices were observed by the FCA in their Thematic Review TR15/12: *Wealth management firms and private banks Suitability of investment portfolios December 2015*. The FCA commented that firms providing retail discretionary and advisory investment management services may want to consider how their arrangements measured up against the following examples. The individual examples listed in the table below are from a variety of firms within the sample and are not derived from one firm or file, unless otherwise stated. This table appears in Annex 2 of TR15/12

| | Good practice? | Poor practice |
|---|---|---|
| Governance and control environment | <p>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.</p> <p>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.</p> <p>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.</p> | <p>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.</p> <p>The firm's own recent review of a sample of files and the FCA's review of a sample files appeared to show ongoing issues with the quality of customer information recorded to demonstrate suitability.</p> <p>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.</p> <p>Insufficient consideration was given to other potential risks, such as the portfolio not being suitable in the first place. The FCA's 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.</p> |

| | Good practice? | Poor practice |
|--|---|--|
| Putting oversight arrangements in place | <p>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 (i.e. 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 e.g. in producing client-facing correspondence. The FCA's assessments of this firm's files showed no significant issues with the recorded customer information.</p> <p>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.</p> | <p>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. The FCA's assessments of this firm's files showed issues with the recorded customer information.</p> |
| Carrying out effective monitoring | <p>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.</p> <p>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.</p> | <p>The FCA 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 the FCA undertook for these firms were unable to demonstrate whether the customer portfolio was suitable.</p> |

| | 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. | <p>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.</p> <p>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.</p> |
| Investment objectives | A firm was able to clearly demonstrate its customers' objectives across all of the files the FCA 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. | <p>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.</p> <p>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.</p> |

| | Good practice? | Poor practice |
|----------------------|--|---|
| Risk appetite | <p>In a number of cases the FCA 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.</p> <p>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. The FCA noted that the final risk appetite in these cases would be adjusted appropriately and agreed with the customer.</p> <p>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.</p> | <p>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.</p> <p>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.</p> <p>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.</p> <p>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.</p> |

| | Good practice? | Poor practice |
|---|--|---|
| Risk appetite (continued) | | <p>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 the FCA's 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.</p> <p>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.</p> |
| Matching the customer's portfolio with risk appetite | <p>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.</p> <p>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.</p> <p>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.</p> | <p>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.</p> <p>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.</p> <p>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.</p> |

| | Good practice? | Poor practice |
|-----------------------------------|---|---|
| Investment time horizon | In a number of cases the FCA reviewed it was noted that firms had annually reviewed a customer's investment time horizon. | <p>In a high number of cases the FCA 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 the FCA to assess a number of cases as unclear.</p> <p>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.</p> |
| 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. |
| Capacity for loss 26 | In a number of cases the FCA reviewed it was noted that firms had reviewed a customer's capacity for loss annually. | Many firms within the FCA's sample had failed to demonstrate from the information on file whether they had considered a customer's capacity for loss. |

The main functions of the Suitability Report are to set out the client's current position and objectives and to make recommendations about how changes should be made to achieve those objectives. Many people find reading about financial matters unfamiliar and difficult therefore it is important to make it easy to read.

A logical structure to a report might be:

- an introduction explaining the purpose of the report
- a description of the client's current financial and personal position
- a section setting out the client's aims and needs, possibly covering current cash flow needs, mortgage needs, protection issues, retirement income, investment, and estate planning
- recommendations in each area where a need has been established
- review procedures and further work
- revisions, reviews and monitoring.

Once the report is written it is worth re-examining it to see if the contents could be presented in a more user-friendly way. There can be a substantial amount of information that needs to be included, but it may be possible to place some of the detail in schedules or appendices, particularly if this will help make the main body of the report more approachable. Try to make sure that such detail which is included is relevant and that there is not too much standard wording which obscures the more important elements of the report. The FCA may well adversely comment on standard wording which is not relevant in a specific context: indeed they have done this in their review work. It might be possible to omit detail which is included in the brochures and key feature documents that must be provided to the client. You should also ensure that the use of jargon is kept to the minimum – only to be used where absolutely necessary – and that it is written in language that the client will understand. Indeed, the way that a report is laid out can make it easier to read, for example headings help readers see where they are in the document and can make the document less intimidating. Also tables and graphs can explain the recommendations and are useful in breaking up the text.

2.5 COMMUNICATIONS

The FCA's detailed rules on communications can be found in the Conduct of Business Sourcebook (COBS 4.5.2). This requires firms to ensure that general information:

- a) includes the name of the investment firm,
- b) is accurate and always gives a fair and prominent indication of any relevant risks when referencing any potential benefits of an investment service or financial instrument,
- c) uses a font size in the indication of relevant risks that is at least equal to the predominant font size used throughout provided, as well as a layout ensuring such indication is prominent,
- d) is sufficient for, and presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received,
- e) does not disguise, diminish or obscure important items, statements or warnings,
- f) is consistently presented in the same language throughout all forms of information and marketing materials that are provided to each client, unless the client has accepted to receive information in more than one language,
- g) is up-to-date and relevant to the means of communication used.

In deciding whether, and how, to communicate information to a particular target audience, a firm should take into account the nature of the product or business, the risks involved, the client's commitment, the likely information needs of the average recipient and the role of the information in the sales process. It should also consider whether omission of any relevant fact will result in information being insufficient, unclear, unfair or misleading.

Communications with customers, whether oral or written, should be fair, clear and not misleading and serve their purpose (COBS 4.2). COBS also applies to communications arising from existing investment business with the client, to financial promotions made and other documentation produced for client consumption. This is so that a customer can understand how and why recommendations meet his needs and objectives and why a particular promotion is being made.

Information about an adviser's services is communicated through the Client Agreement while product information is included in Key Features documentation. If a firm is advertising then financial promotions also need to adhere to the general rules on communications listed above.

2.6 MONITORING AND REVIEWING

Once a financial plan has been put in place, it needs to be regularly monitored and reviewed. This is necessary because advice can become out of date with changes to personal circumstances or because external aspects, such as the economy and tax rules, have changed. Also, some of the customer's priorities might require action to be taken at a later date.

Plans should be reviewed in the light of how investments have performed and any other changes that might have taken place. An update to the factfind data is essential before further advice can be given.

If there has been a shortfall in investment returns it might be necessary to look at the investment mix to see if the shortfall can be made up by switching investment classes, or whether further saving may be required for the customer to achieve his goal. Also, the investment portfolio might need rebalancing so that it conforms to the client's risk profile. In addition there might be tax implications to be taken into account.

A customer's personal circumstances are also likely to change, and these changes can be rapid in some cases. Life events – e.g. marriage, parenthood, divorce, job changes, redundancy and retirement – can be either planned or unplanned and the financial plan will need to be adapted where necessary to reflect these events.

A financial review should also take place close to the time when a policy matures or a mortgage or other loan is to be redeemed.

Depending on the client, reviews should be annual; however for some clients (e.g. High Net Worth clients with substantial investment portfolios and IHT needs) more frequent reviews may be required while for others reviews may be less frequent. This will be set out and agreed in the client's terms of engagement document. The aim of the review should be to keep the financial plan of a client up to date. This requirement has been emphasized in MiFID II. The FCA will expect ongoing suitability letters to include Buy, Sell or Hold recommendations for specific investments.

The FCA expects firms and advisers to:

- provide evidence that the firm regularly collates, analyses and uses management information to ensure its processes deliver fair outcome for its customers
- demonstrate that the quality of advice provided to customers is adequately monitored to ensure its suitability
- demonstrate that the firm identifies issues in any given area that could impact on the quality of advice given to customers
- act upon findings appropriately and promptly ensuring remedial action is monitored, and
- continuously seek to assess and improve these processes and practices, reviewing these regularly or when there is a change in the firm's structure, business practices and/or strategy (this aspect was emphasised recently in Thematic Review, TR16/1, Assessing Suitability Research and Due Diligence).

2.7 CANCELLATION RIGHTS

Cancellation terms can be very complex and the COBS 15.2 rules are detailed. The precise nature of the products package being offered would determine the length of the cancellation right period and as such it would be incumbent on the product designers to ensure that sufficient cancellation rights are given. In the event of any doubt then it would be expected that the interests of the consumer are put before those of the product provider (or adviser). The adviser's role would be to ensure that the relevant cancellation terms are given to their clients. But then if suitable advice has been properly delivered then cancellation is unlikely to occur in any event.

A client has a right to cancel any of the following contracts (extract from COBS rules):

| Cancellable contract | Cancellation period |
|---|---------------------|
| Life and pensions | |
| <ul style="list-style-type: none"> a life policy (including a pension annuity, a pension policy or within a wrapper) a contract to join a personal pension scheme or a stakeholder pension scheme a pension contract a contract for a pension transfer a contract to vary an existing personal pension scheme or stakeholder pension scheme by exercising, for the first time, an option to make income withdrawals | 30 calendar days |
| Non-life/pensions | |
| <ul style="list-style-type: none"> to buy a unit in a regulated collective investment scheme (including within a wrapper or pension wrapper) to open or transfer a child trust fund (CTF) to open or transfer an ISA for an Enterprise Investment Scheme accepting deposits designated investment business issuing electronic money | 14 calendar days |
| <ul style="list-style-type: none"> If the same transaction (perhaps a package of different investments) attracts more than one right to cancel, the firm should apply the longest cancellation period applicable. A firm may provide longer or additional cancellation rights voluntarily. If the right to cancel applies to a wrapper or pension wrapper and underlying investments, the firm may give the consumer the option of cancelling individual components separately if it wishes. | |

The firm must disclose to the consumer:

- in good time before or, if that is not possible, immediately after the consumer is bound by a contract that attracts a right to cancel or withdraw; and
- in a durable medium, e.g. in writing,

the existence of the right to cancel or withdraw, its duration and the conditions for exercising it including information on the amount which the consumer may be required to pay, the consequences of not exercising it and practical instructions for exercising it indicating the address to which the notification of cancellation or withdrawal should be sent.

If the firm offers to facilitate, directly or through a third party, the payment of adviser charges or consultancy charges, it must disclose to the consumer at the same time as it makes the disclosure above:

- whether any refund will include an adviser charge or consultancy charge; and
- that the consumer may be liable to pay any outstanding adviser charge or consultancy charges.

This rule applies only where a consumer would not otherwise receive similar information under a rule in the FCA sourcebook from the firm or another authorised person (such as under the distance marketing disclosure rules or providing product information).

The cancellation period begins:

- either from the day of the conclusion of the contract, except in respect of contracts relating to life policies where the time limit will begin from the time when the consumer is informed that the contract has been concluded, or
- from the day on which the consumer receives the contractual terms and conditions and any other pre-contractual information, if that is later than the date referred to above.

If a firm does not give a consumer the required information about the right to cancel and other matters, the contract remains cancellable and the consumer will not be liable for any shortfall.

If a consumer exercises his right to cancel he must, before the expiry of the relevant deadline, notify this following the practical instructions given to him. The deadline shall be deemed to have been observed if the notification is dispatched before the deadline expires.

A consumer does not need to give any reason for exercising his right to cancel.

The firm should accept any indication that the consumer wishes to cancel as long as it satisfies the conditions for notification. In the event of any dispute, unless there is clear written evidence to the contrary, the firm should treat the date cited by the consumer as the date when the notification was dispatched.

The firm must make adequate records concerning the exercise of a right to cancel or withdraw and retain them:

- indefinitely in relation to a pension transfer, pension opt-out or FSAVC
- for at least five years in relation to a life policy, pension contract, personal pension scheme or stakeholder pension scheme
- for at least three years in any other case.

By exercising a right to cancel, the consumer withdraws from the contract and the contract is terminated.

When the consumer exercises his right to cancel he may be required to pay, without any undue delay, for the service actually provided by the firm in accordance with the contract. The performance of the contract may only begin after the consumer has given his approval. The amount payable must not:

- exceed an amount which is in proportion to the extent of the service already provided in comparison with the full coverage of the contract
- in any case be such that it could be construed as a penalty.

The firm may not require the consumer to pay any amount unless it can prove that the consumer was duly informed about the amount payable. However, in no case may the firm require such payment if it has commenced the performance of the contract before the expiry of the cancellation period without the consumer's prior request.

Summary

In this Chapter we looked at the detail of how professional standards are regulated by the Financial Conduct Authority (FCA) and how these standards together with FCA regulations operate in the advice process, including in the construction of the Suitability Report/Letter. In this we have evaluated the importance of professional standards and judgement in establishing and maintaining client relationships, needs and priorities.

Finally we have considered the client's cancellation rights

Self Test Questions

- In addition to the personal customer information, what other information should an adviser gather?
- What should an adviser consider when preparing a suitability report? List 9 items.
- Describe the FCA's requirements when a firm communicates with customers.
- What monitoring does the FCA expect firms and advisers to carry out?
- What are a client's cancellation rights?

PART 3

INVESTMENT ADVICE AND PLAN

OVERVIEW

This Part, which explores investment advice, investment performance and investment planning, consists of three Chapters.

In Chapter 1 we consider investment risks and theory and then asset allocation generically before we apply this background knowledge to specific client circumstances in Chapters 2 and 3.

In Chapter 2, we consider investment advice and explain how “know your client” affects asset allocation and we place this in the context of investment planning and performance monitoring.

In Chapter 3, we will look at how a portfolio is constructed, at portfolio performance and at portfolio reviews.

The student may wish to review the macro-economic background and investment products which are available: these were considered in the Taxation, Retail Investment and Pensions unit. The principles of asset allocation, investment advice and portfolio construction which we are considering in this Part constitute the regulated advice requirements in using the investment products available.

CHAPTER 1

Asset Allocation and Risk

INTRODUCTION

Before an adviser provides recommendations about the type of investments a client should make, it is important that the client's objectives regarding investment return requirements and investment risk tolerance are understood.

We consider this client-specific risk aspect, time horizons for specific client investments and associated matters in Chapters 2 and 3 but for this Chapter we need to consider non-client risk issues as a backcloth against which specific client needs may be viewed.

1.1 MAIN TYPES OF RISK

In addition to specific client risk issues which we will look at in Chapters 2 and 3, there are generic types of risk which impact on investment returns and which need to be understood by the adviser.

Systematic v Unsystematic Risk

Risk can be categorised in different ways. The main categories of risk are:

- Market risk (systematic risk) – this is the risk that there might be a reduction in expected return as a result of a fall in the stock market generally, and
- Investment-specific risk (unsystematic risk) – this is the risk that there might be a reduction in the expected return as a result of some event or circumstance specific to a particular company.

Inflation Risk

Inflation is a major consideration in any investment plan. To achieve real returns on an investment the percentage increase in the investment must be greater than the prevailing rate of inflation.

Interest Rate Risk

This is important for fixed income and variable rate securities and it is important to differentiate between the two:

- Where an investment, such as a bond, has a fixed rate of return variation in the interest rate will affect their capital value. When interest rates rise, fixed-rate bond values fall and vice versa.
- On the other hand, with a variable rate building society account or other variable rate security, it is the income which will fall if interest rates fall.

Credit Risk

There are three types of credit risk:

- default risk – the risk that a fixed-interest investment will fall when investors decide that the probability of non-payment of interest or the collapse of the issuing organisation has increased
- downgrade risk – the risk that the market anticipates that a credit rating agency is going to reduce the rating of a bond (or even a country when we are considering government bonds)
- credit spread risk – when investors become nervous there is a flight to quality (e.g. Government bonds) which may well result in corporate bonds underperforming (particularly those so-called “junk” bonds of weak companies). This is a result of the widening of credit spreads, i.e. the difference between the yields of different types of bonds.

Currency Risk

This is the risk that when investing overseas any capital growth can be wiped out if sterling appreciates against the currency the investment is in. Also, if the investment is in a company that relies on exporting its products overseas and the currency appreciates where the goods are manufactured or the local currency depreciates, this will affect the profitability of the company.

Liquidity Risk

This is the risk that an investor may need to sell securities at a price below its fair value due to a lack of willing buyers for that particular security.

Operational Risk

This is a risk which can arise from the investment process, including settlement and counterparty risk, fraud, misrepresentation, systems failure, unauthorised trading, staff errors and regulatory risk.

Event Risk

This is where the issuer of a security is unable to pay interest or repay capital because of a major unexpected occurrence such as a natural disaster, a corporate change or a regulatory change.

Political Risk

A new Government may have different fiscal and monetary objectives which can affect investment values positively or negatively. Similarly World events can also produce or relieve tensions which impact on investment markets.

Emerging market Risk

There are a number of risks that arise when investing in emerging markets. They tend to have less regulation and poor systems of checks and balances. These weaker accounting audit procedures increase the chance of corporate bankruptcy or even corrupt practices. There are political risks that could result from adverse political decision or instability. In addition, there are the currency risks associated with investing overseas.

1.2 INVESTMENT THEORIES

1.2.1 Modern Portfolio Theory

Modern Portfolio Theory (MPT) is concerned with the way in which portfolios can be constructed to maximise returns and minimise risks. MPT was developed in the 1950s following the publication by Harry Markowitz of his paper "Portfolio Selection" in the American *Journal of Finance*. He began: "The process of selecting a portfolio may be divided into two stages. The first stage starts with observation and experience and ends with beliefs about the future performances of available securities. The second stage starts with the relevant beliefs about future performances and ends with the choice of portfolio. This paper is concerned with the second stage." He went on to illustrate his thinking in a way which will satisfy the actuarial student, but for this study manual, suffice it to say that Markowitz was a talented young mathematician and economist who recognised that investment theory at the time lacked an analysis of the impact of risk. (If that seems strange, just remember that there were no readily accessible computers or any calculators then. Even modern insurance companies were still using mechanical calculators 20 years after that time, with electronic calculators only just beginning to appear in the early 1970s! Any analysis needed to be done manually: just try one long division using numbers with half a dozen digits! And as for compounding ...!)

Markowitz took into account investors' beliefs about future investment performance of available securities. MPT considers the changes in price of each investment relative to the price changes for every other investment in the portfolio. The theory assumes that the investors are risk-averse and, if offered a choice, would choose less risky investments if they had the same return. The underlying principle is that a rational investor would not invest in a portfolio if an alternative was available with a more favourable risk-return profile.

A low risk portfolio can be constructed by simply buying low risk assets, but this will usually lead to low returns. An alternative would be to buy more risky assets that are more likely to give higher returns and then to reduce the risk. This can be done in one of two ways, either by diversification of the portfolio holdings, i.e. holding a range of different types of assets, or by hedging out the risk.

By hedging, an existing investment position is protected by taking another position that will increase in value if the existing position falls in value. This can be achieved by using derivatives such as a futures contract.

The degree of correlation between the returns on investments in the portfolio will determine how effectively it has been diversified. The most effective diversification is achieved when investments which are negatively correlated are combined, i.e. move in opposite directions to each other, but this is not always easy to find. In practice, investors may have to choose investments that are not correlated, i.e. where profits and share values are not related to each other, or where the correlation is as low as possible. Where a portfolio is diversified it is possible to eliminate unsystematic risk. Diversification can also be achieved by:

- holding different asset classes within the portfolio
- choosing companies from different sectors
- including overseas companies.

1.2.2 Capital Asset Pricing Model (CAPM)

Unsystematic or asset-specific risks can be removed through diversification, but the same approach does not solve the problem of systematic or market risk. The capital asset pricing model (CAPM) was put forward as a way to measure systematic risk.

Systematic risk is measured by beta, which indicates the volatility of a stock relative to the market. The market as a whole has a beta of 1. If a share price moves exactly in line with the market, then the stock's beta is 1.

Where a security has a beta of more than 1 it exaggerates the market's movement. This would mean that a security with a beta of 1.2 rises by 12% if the market rises by 10%, and falls by 12% if the market falls by 10%. Securities, with a beta greater than 1, are often known as aggressive securities. A security with a beta between 1 and zero is more stable than the market and will move less than the market but in the same direction. These securities are often known as defensive securities.

The CAPM derives the theoretical expected return from the security as a combination of the return on a risk-free asset and compensation for holding a risky asset, i.e. the risk premium. It is usually expressed as:

$$E(R_i) = R_f + \beta_i (R_m - R_f)$$

where:

$E(R_i)$ is the expected return on the risky investment R_f is the risk free rate

β_i is the beta of the security

R_m is the expected market return $(R_m - R_f)$ is the risk premium.

CAPM assumes that:

- investors make decisions on the basis of risk and return alone
- all investors have an identical holding period
- no one individual can affect the market
- there are no taxes, transaction costs or restrictions on short selling
- all investors can borrow and lend unlimited amounts of money at the risk-free rate
- the quantity of risky securities in the market is fixed.

There are limitations to CAPM (and that will be quickly apparent from reading the above assumptions). Finding a totally risk-free return is difficult, and it is common to pick the return on UK Government Treasury bills. Also, in theory the CAPM market portfolio includes all risky investments worldwide, but in practice this is usually replaced by a particular national stock market index, e.g. FTSE All-Share or FTSE100 (the latter is also known as the Footsie). However, depending on which index is used, the betas can be significantly different.

1.2.3 Multi Factor Models

The CAPM expresses a simple relationship between risk and return and, therefore, is often referred to as a single factor model. Multi factor models use a number of factors in the calculations used to explain market movements and asset prices. This type of model can be used to explain either an individual security or a portfolio of securities. It will compare two or more factors to explain the relationship between variables and the security's resulting performance.

Factors are compared using the following formula:

$$R_i = a_i + \beta_i(m) R_m + \beta_i(1)F_1 + \beta_i(2)F_2 + \dots + \beta_i(N)F_N + e_i$$

where:

R_i is the return on security i R_m is the market return

$F(1,2,\dots,N)$ is each of the factors used

β is the beta with respect to each factor including the market (m)

e is the error term

a is the intercept

These models are used to construct portfolios with certain characteristics, such as a particular risk profile, or to track indexes. Different models will take account of different factors and the number of factors taken account of will vary. An example of a three factor model is the Fama and French model which considers size of firms, book-to-market values and excess return on the market.

Multi-factor models can be divided into three categories:

- macroeconomic models that compare a security's return to such things as employment, inflation and interest rates
- fundamental models that look at the relationship between a security's return and its underlying financials, such as earnings, and
- statistical models that are used to compare different securities' return by looking at the statistical performance of each security.

One of the best known multi factor models is the Arbitrage Pricing Theory (APT). This is an asset pricing model, proposed by the economist Stephen Ross in 1976, which uses the relationship between an asset and many common risk factors to predict an asset's return. It predicts a relationship between the returns of a portfolio and the returns of a single asset by looking at a number of independent macroeconomic variables. If the market price is out of line with the predicted price then the arbitrageur can take advantage of the expected correction, before the market in general catches up.

APT is often viewed as an alternative to CAPM because it offers more flexible assumption requirements. (CAPM can be regarded as a simplified example of APT.) Rather than being limited to using the market's expected return, APT uses the risky asset's expected return and the risk premium of a number of macroeconomic factors.

One difficulty with APT is its generality, i.e. it does not tell the user which factors are relevant. Also, the number and nature of the factors is likely to change over time and between economies. In addition, the inclusion of multiple factors requires more betas to be calculated and there is no guarantee that all of the relevant factors have been identified.

Mathematicians continue to debate the capabilities of different models and how they cope with anomalies thrown up by the market in practice. From time to time new models and adaptations to existing models emerge. But it might be worth bearing in mind that "the race is not ...to men of understanding, nor yet favour to men of skill": and as Ecclesiastes 9:11 continues "time and chance happeneth to them all". Put another way, no matter how mathematically brilliant an investment theory, if the timing of an investment is wrong or if an unexpected event interposes then one investment manager's investment returns may still not be as good as another's no matter how all-encompassing his model is claimed to be.

In the next section we consider ways of comparing different investment managers. The parameters used in this are much more likely to be encountered by advisers than the theoretical investment ideas used in the attempt to generate returns.

1.2.4 Risk Adjusted Returns

Risk adjusted returns are used to quantify an investment's return by measuring the degree of risk which is involved in producing a given return. This is generally expressed as a number or rating. It can be applied to individual securities and investment funds and portfolios. There are perhaps six principal risk measures: alpha, beta, information ratio, r-squared, standard deviation and the Sharpe ratio. (There are other yardsticks but the following summarises the most-frequently-met-with measures). An investor and his adviser should ensure that the same risk measure is used when comparing two or more investments.

Alpha

Alpha is the difference between the return you would expect from a security, given its beta, and the return that it has actually produced. It represents the under or out performance of an investment in relation to its benchmark. A positive alpha indicates that a security has performed better than predicted by its beta and a negative alpha indicates that it has performed worse than predicted. Alpha allows the investor to quantify the value added or taken away by a manager through active management. It can be calculated as follows:

$\alpha = \text{actual portfolio return} - [R_f + \beta_i (R_m - R_f)]$ where:

R_f is the risk free rate of return

β_i is the beta of the fund or portfolio R_m is the market return.

Beta

Beta is a measure of a stock's volatility vis-à-vis the market as explained further under CAPM above.

Information ratio

The information ratio, sometimes called the appraisal ratio, is used to assess the risk-adjusted performance of active portfolio managers. It measures the relative return achieved by an investment manager divided by the amount of risk the manager has taken relative to the benchmark. The relative return, which can be positive or negative, is the difference between the return on the actively managed portfolio and the return on the benchmark. The risk taken relative to the benchmark is the tracking error, which is the standard deviation of the relative returns.

$$\text{Information ratio} = \frac{R_p - R_b}{\text{Tracking Error}}$$

where:

R_p is the portfolio return

R_b is the benchmark return.

The higher the positive information ratio, the higher the value added by the manager through active management, based on the amount of risk taken relative to the benchmark. A negative ratio indicates that an investor would probably have achieved a better return by matching the index using a tracker or index fund.

R-squared

R-squared is another indication of how closely a fund is correlated to an index or a benchmark. It can be expressed as a percentage or as a value between 0 and 1, showing what proportion of a fund's movements can be attributed to those of the benchmark. Values over 0.75 indicate that the fund's behaviour is linked to its benchmark, while an r-squared below 0.5, indicates that the correlation is weak. Interestingly, if the fund has a low r-squared measure then this could indicate a creditable performance for an active fund manager. On the other hand, a tracker fund could be expected to have an r-squared measure closer to 1 (or 100%)

Tracking error can be regarded as the inverse of r-squared. Tracking error refers to the amount by which the return on an asset departs from the benchmark. A fund with a high tracking error is not expected to follow the benchmark closely and will generally be regarded as risky.

Standard deviation

Standard deviation is a measure of volatility of returns. It measures how widely the actual return on an investment varies around its average or expected return. An investment with returns that stay close to its expected returns is said to be low risk and has a low standard deviation. An investment with returns that fluctuate wildly may have the same expected return, but is described as high risk and has a higher standard deviation of returns. The greater the standard deviation around the expected return, the more volatile and hence risky the investment is.

Sharpe ratio

The Sharpe ratio measures the excess return for every unit of risk that is taken to achieve the return. It is a method for comparing different risk/reward options and, in general, the higher the Sharpe ratio the better the return on an investment compensates an investor for the risk taken. The ratio is:

$$\frac{\text{return on the investment} - \text{risk free return}}{\text{standard deviation of the return on the investment}}$$

The difference between the return achieved by the investment and the risk free rate of return is the excess return received for taking some risk. Risk is measured by the standard deviation of returns.

1.2.5 Efficient Market Hypothesis (EMH)

Efficient Market Hypothesis (EMH) argues that it is impossible to “beat the market” because stock market efficiency means that existing share prices always incorporate and reflect all relevant information. According to this theory, securities always trade at their fair value on stock exchanges, therefore it is impossible for investors to either purchase undervalued securities or sell them for inflated prices. Based on this theory it should be impossible to outperform the market through expert stock selection or market timing, and the only way to obtain higher returns is by purchasing riskier investments.

There are three identified classifications of the EMH, which differ in respect of the information that they consider. *Strong efficiency* – This states that security prices reflect all the information in a market, whether public or private. Not even insider information could give an investor an advantage.

Semi-strong efficiency – This states that security prices are adjusted to take account of all the public information that is available. This implies that neither fundamental nor technical analysis will reliably be able to help identify whether a security is over or undervalued.

Weak efficiency – This states that the current price of a security reflects all past prices and trading volume information and that future prices cannot be predicted by analysing this type of historical data. Therefore, technical analysis cannot be used to predict and beat a market.

The debate about the efficiency of markets plays an important role in the decision between choosing active or passive investment. If EMH is correct, instead of picking stocks it makes sense to invest in tracker or index funds, which will mirror the overall performance of the market. But where markets are less efficient knowledgeable investors might have an opportunity for outperformance.

1.2.6 Behavioural Finance

Behavioural finance considers how emotional and psychological factors affect investment decisions. It attempts to explain market anomalies and activity that is not explained by the traditional finance models and offers alternative explanations to why security prices deviate from their fundamental values. Many traditional financial theories are based on the idea that investors act rationally and consider all the information before investing, but behavioural finance argues that psychological and behavioural factors affect investors.

Prospect theory deals with the idea that people do not always behave rationally. Research has shown that investors place different weights on gains and losses and on different ranges of probability. Individuals are much more distressed by prospective losses than they are happy by equivalent gains. It has also found that people play safe when protecting a gain, but if faced with the possibility of losing money they will often take riskier decisions in an attempt to avoid a loss, e.g. they may hold on to losing investments longer than they should in the hope that given time the loss will be recouped.

A key behavioural factor, and perhaps the one thing that explains market anomalies, is overconfidence. People have a tendency to overestimate their own skills and predictions for success and underestimate the likelihood of bad outcomes over which they have no control. Investors tend to be more optimistic when the market goes up and more pessimistic when the market goes down, which can lead to speculative bubbles or spectacular crashes.

1.3 TIME VALUE OF MONEY

The time value of money is the concept that the value of the money you have now is not the same as it will be in the future. Neither is the future value of money equivalent in real terms to what it is now. The present value and future value of money are highly likely to be different because inflation erodes the real value of money. In the same way, the monetary value of, say, a person's home in 2017 will be vastly greater than the monetary value of the same house thirty years ago: but will that property's real value be significantly different?

Being able to calculate the time value of money will mean that an investor can distinguish between the values of investments at different times.

There is a market rate that can be used to determine how the value of money changes over time. When investors buy Government bonds they are exchanging cash now for a certain amount of money on a future date. Therefore this risk free rate of return can be used to calculate the present value of a certain future payment.

If a future payment is not certain its value needs to be adjusted for risk as well as time value. Its present value needs to be calculated using a discount rate that reflects both time value and risk. This adjustment for risk might be necessary if the future payment is, for example, the repayment of a corporate bond issued by a company not regarded as having the best of credit ratings (see section 1.1, Main Types of Risk above).

Present Value of a Single Sum – The equation below calculates the current value of a single sum to be paid at a specified date in the future. This value is referred to as the present value (PV) of a single sum. In effect, this equation discounts a future value back to the present day.

$$PV = FV / (1 + i)^n$$

where:

PV is the present value

FV is the future value

n is the number of compounding periods

i is the interest rate.

Future Value of a Single Sum – The equation below calculates how large a single sum will become at the end of a specified period of time. This value is referred to as the future value (FV) of a single sum.

$$FV = PV(1 + i)^n$$

Compound Growth

Compound interest means that interest is earned on interest. Compounding magnifies the impact that a given interest rate has on the growth of the principal invested. Sometimes, as will be illustrated below, this impact can be dramatic.

There are two ways in which compounding exerts its influence:

- the compounding **frequency or interval** (the greater the number of compounding periods in a year, the greater the impact); and
- the **term** (the number of years over which the compounding takes place).

Example. What is the value of £100 invested for 1 year at 12%?

For annual interest, there is no compounding effect because the term is only one year, the same as the compounding frequency. Thus, all we have is simple interest with a single interval or rest.

$$FV = £100 \times 1.12 = £112.00$$

Simple interest is also met with over periods longer than one year. A good example is the increase in the starting amount of State pension benefits if payment is deferred: for each nine week period of deferment (five weeks before April 2016) after State Pension Age (SPA), State Pension benefits increase by 1% of the amount at SPA. Assume someone is entitled to State Pension benefits of £100 per week. If they defer payment for nine weeks their pension will start at £101 per week. If they defer their pension for 90 weeks the pension will start at £110 per week. If they defer their benefits for 180 weeks then the starting pension will be £120 per week. With simple interest there is no interest added to earlier interest accruals. Simple interest calculates interest only on the original sum.

Where *compound interest* is added every 6 months, half of the nominal interest rate of 12%, i.e. 6%, is added at each compounding interval

$$FV = £100 \times 1.06 \times 1.06 = £112.36$$

“£100 x 1.06 x 1.06” can also be expressed as $£100 \times (1.06)^2$

Where interest is added every month, 1/12th of the interest rate, i.e. 1%, is added at each compounding interval (there are 12 compounding intervals for this next example)

$$FV = £100 \times (1.01)^{12} = £112.68$$

The longer an amount is subject to compounding, the greater the effect. Also, the more frequently interest is compounded, the greater the effect. It is the latter aspect which can make loans very expensive and which, when transaction and rollover costs are added in, produces the extremely high Annual Percentage Rates (often much more than a 1000% pa) which information pay-day loan companies must include in the advertisements. From an investment viewpoint the beneficial effect of compounding will be more noticeable with longer-term investments. Further Examples below illustrate the power of compound interest over longer terms.

Examples

Extending the example above where interest, nominally 12%, is added every month, 1/12th of the interest rate, i.e. 1%, is still added at each compounding interval. But let us also assume that the term is 10 years and 25 years and we get the following results:

$$FV = £100 \times (1.01)^{12} = £112.68$$

$$FV = £100 \times (1.01)^{120} = £330.04$$

$$FV = £100 \times (1.01)^{300} = £1,978.85$$

Note that in all the above examples, the annual compound rate, or APR if you are looking at a loan, is 12.68%. The same FV results will be obtained by substituting 1.1268 (actually 1.126825 to 6 decimal places) for $(1.01)^{12}$. Contrast the above results with simple interest over the same periods (note that the formula differs slightly from the first simple interest example above because we have monthly rests, though that has no effect for simple interest):

$$FV = £100 + ((100 \times 0.01) \times 12) = £112$$

$$FV = £100 + ((100 \times 0.01) \times 120) = £220$$

$$FV = £100 + ((100 \times 0.01) \times 300) = £400.$$

The Future Value figures produced by compounding when contrasted with the simple interest results become much greater the longer the period and the higher the interest rate, or the higher the growth rate for investment purposes. Students not familiar with compound interest might like to look at the further examples which follow and think of their relevance in terms of charges and fund growth for a young 20-year old client who sets up a personal pension from which he still draws down a pension some 60 years later.

Examples

For these examples we use varying annual rates of growth over different periods, £100 capital in each case and annual compounding:

| Term | Rates of Growth | | | |
|----------|-----------------|-----------|------------|---------------|
| | 1% | 5% | 10% | 20% |
| 1 year | £101.00 | £105.00 | £110.00 | £120.00 |
| 5 years | £105.10 | £127.63 | £161.05 | £248.83 |
| 10 years | £110.46 | £162.89 | £259.37 | £619.17 |
| 20 years | £122.02 | £265.33 | £672.75 | £3,833.76 |
| 40 years | £148.89 | £704.00 | £4,525.93 | £146,977.16 |
| 60 years | £181.66 | £1,867.92 | £30,448.16 | £5,634,751.44 |

Remember that each figure in the above table starts off with a single amount of £100. Nothing is added nor taken away in these examples. The only variables are Term and Rate of Growth. If you are not familiar with the long-term effect of compound interest, try to work out manually (or more likely by putting a constant into your calculator) and verify the 60 years at 20% yourself. (Infamously, in the 1980s certain of the then newer life assurance companies were quoting for yields around the 20% p.a. level: £20 per month to a pension was shown to easily produce a fund in excess of £1,000,000 for a young worker. One of the first steps taken by the predecessors of the FCA was to limit the growth rates which could be used in quotations and to insist that warnings be added re investment growth not being guaranteed.)

Think also about the quoted long-term average growths for deposits vs. equities which are often met with: how much difference could result over a long period from even a modest interest rate differential? Advisers should not overlook the cost to a client of servicing his credit card debt and the impact of that on affordability of any savings products recommended. (You could also consider pay day loans in this context, substituting months where years appear in the above table and use the 20% column – 20% is not the top monthly rate for some pay-day loan companies. Frightening!)

1.4 ASSET ALLOCATION

Asset allocation is basically a strategy designed to preserve capital and reduce the risk element by using diversification within investments. The theoretical approach to asset allocation uses mathematical analysis and techniques to obtain the desired risk-return trade-off, i.e. the maximum return for with a given level of volatility or the lowest volatility for a desired rate of return. These in turn create an “optimal” portfolio from sets of asset classes using historical data on risk and returns. Alternatively, practitioners can simply analyse long-term average rates of return from the relevant asset classes together with historical data on the range of these returns.

To create an appropriate portfolio for an investor, the adviser needs to understand the investor's risk tolerance and their target returns. The next Chapter discusses the investor's Attitude to Investment Risk in more detail. For an adviser to apply asset allocation he must have a set of risk profiles which correspond to the preferences and risk tolerance of clients. For example, these might be broken down into Cautious for low risk investors, Balanced for medium risk investors and Growth for medium to high risk investors. The allocation to specific asset classes in each of these profiles might be along the lines of:

Cautious – 15% in cash, 35% to 40% in fixed interest, 10% to 15% in property, 30% to 40% in equities

Balanced – 10% in cash, 30% in fixed interest, 10% to 15% in property, 45% to 50% in equities

Growth – 5% in cash, 15% to 25% in fixed interest, 10-5% in property, 55% to 65% in equities.

Each advising firm will undertake or have access to research which gives a full range of investment profiles to suit the attitudes to risk of different investors. This research will mean that the suggested splits between asset categories shown immediately above will change from time to time. The categories themselves can also be further sub-divided: fixed interest into corporate and Gilts, or Equities into UK, US, Far East and Emerging Markets, for example.

1.4.1 Strategic Asset Allocation

Strategic asset allocation is used for the long term and is usually only adjusted if the investor's requirements or circumstances change. It creates a portfolio of different asset types, such as equities, bonds, property and cash, to meet an investor's targets. Most advisers using asset allocation will focus on strategic asset allocation because if they have identified the investor's requirements and risk tolerance then, in theory, there is an ideal asset allocation to which their portfolio should conform.

1.4.2 Tactical Asset Allocation

Tactical asset allocation uses an allocation model which gives a range for the percentage of capital in each investment. Tactical decisions can be made to deviate from a portfolio's strategic or long term asset mix to take advantage of short term investment opportunities, based on economic or market developments. Changes in economic conditions can lead to a short term under-performance or out-performance of one asset class over the other or of a certain sector within an asset class over other sectors. Fund managers can take advantage of these developments by making changes to the portfolio's asset mix, by increasing or reducing the holdings in a particular asset class. Once the economic or market developments have taken their course, the fund manager can return the portfolio's asset mix to the long term position.

Summary

Before an adviser makes recommendations about the type of investments a client should make it is important that all the client's objectives, including those regarding return requirements and expectations and risk tolerance are understood. Once the adviser has this insight, they will be able to create an appropriate portfolio for an investor. This Chapter looked at the different types of risk and how asset allocation can be used to reduce risks and maximise returns.

Self Test Questions

- What are the five risk classes that investors fall into?
- What is compound growth?
- Compare the Efficient Market Hypothesis with Behavioural Finance.
- Is a Sharpe ratio of 1.5 better than or worse than a Sharpe ratio of 2? And why?
- What is the time value of money?
- What is asset allocation?

CHAPTER 2

Investment Advice

INTRODUCTION

Providing investment advice involves balancing the emotional and financial needs of the client against the expected, but rarely certain, performances of various investments. Providing it to a consistent standard requires the adviser to adopt and adhere to a clear defined process. Also, by engaging the client in the process and ensuring the client fully understands the implications of major decisions, optimal results should be achieved.

In Part 2, Chapter 2, we considered advice against the regulatory background, starting with establishing a relationship and working through to reviewing existing clients' ongoing needs. The process of providing investment advice specifically includes the following elements:

- defining the client/adviser relationship with respect to investment goals
- gathering client data, determining goals, expectations and any ethical issues
- creating a risk profile
- formulating an investment strategy
- selecting investment funds
- choosing wrappers for tax efficiency
- presenting and implementing the recommendations
- monitoring the portfolio and making the necessary adjustments.

In Part 2, Chapter 2 we also examined the concept of “know your customer”. We now intend to show how the above-mentioned information is used to decide on the appropriate asset allocation for the client's specific investment profile, whether this advice is limited to, say, capital gain on a specific part of the client's wealth or whether it is part of wider financial advice. The areas to be discussed with regard to investment include:

- establishing a client and adviser relationship
- the client's Attitude to Risk
- time horizons
- formulating an investment strategy.

2.1 ESTABLISHING A CLIENT AND ADVISER RELATIONSHIP

At the start of a client relationship an adviser should provide information about the scope of the investment services that are being offered and the cost of any work that the adviser carries out. This will usually be provided in the Client Agreement, which sets out among other things:

- the basis of remuneration
- the investment services to be provided initially and the timing of reviews (and other services would also need to be covered in the Client Agreement and placed in the context of overall needs and objectives, but we will ignore these for the purposes of this Part)
- the duration of the agreement
- the frequency of contact.

This should ensure that the client has a clear understanding of the amount of reporting on investments they will receive, the frequency of reviewing their circumstances and plans, and whether or not the adviser will alert them to any changes that might be needed to their planning in the future.

The main areas which investment advisers deal with for their clients include:

Investment Monitoring – Updating clients on the short and long term performance of their assets with in depth quarterly, bi-annual or annual investment reports.

Investment Strategy Modelling – Advising on the most appropriate asset allocations for assets, using an asset liability model. Review long term investment strategies on an annual basis and/or three year basis.

Investment Manager Research & Selection – Researching, monitoring and recommending a range of high quality investment managers within the market place across all asset classes from equities, fixed income, property and alternatives.

Asset Transition Management – Coordinating and managing the transfer of assets between asset classes and investment managers.

Again the nature of the investment advice will be spelled out in the Client Agreement.

As explained in Part 2, Chapter 2, gathering client data so that the adviser understands the customer's goals and circumstances is a very important part of establishing a client/adviser relationship. It is essential that the adviser is able to fully explain to the client, in a way that the client will understand, how each product that is recommended meets the identified investment goals and objectives of the client. Any investment option which is put forward to the client needs to be fully described and the relative advantages and disadvantages of any alternatives need to be pointed out.

As discussed in Part 2, for an adviser to understand the client's needs and objectives he will need to go through the following stages:

- recognise the client's needs and objectives
- distinguish between immediate and future objectives
- quantify and qualify the objectives
- prioritise the objectives.

Finding out what clients want to achieve can be a long process. Some clients have a good understanding of their general aims, but many do not. Or it might be that they have a clear idea of some objectives – e.g. a larger retirement fund, a mortgage to buy a house, a bigger income – but may not recognise or understand all their needs.

It is important that an adviser understands the true needs of the client and obtains enough information to ensure that any recommendation is suitable and relates to the client's aims, objectives and circumstances. Clients are likely to have desires or "wants" that are unrealistic in terms of their timescale and cumulative cost. The adviser's role is to identify the client's main needs, prioritise them and establish whether they are achievable with the resources available.

In the investment process all needs can be reduced down to the cash sum (income or capital) needed at certain future dates. By simply explaining this to the client and demonstrating the investment returns and current monetary input required to achieve this, an adviser should be able to get the client to engage with the process of prioritising goals. If the adviser believes the goals are not achievable, then future negotiation over the timescale and outcomes will be required.

2.2 ATTITUDE TO RISK

Ascertaining a customer's true Attitude to Risk is critical for any adviser in assessing suitability and making an investment recommendation. We discussed this in Part 2 but we will recap here as we lead in to our analysis of investment planning.

Risk should be explained in terms that a particular customer can understand. Customers with less experience or knowledge of investments will need a more detailed and yet simpler explanation of the inherent risks involved with the recommendations being made compared with the explanation needed for a more sophisticated client.

Individual customers may have different appetites for risk at different times in their life, dependent on the circumstances and their investment objectives. Firms may have ongoing relationships with customers where they will review a customer's portfolio of investments on a periodic basis and will need to be mindful of the fact that the customer's risk appetite may have changed.

A customer can, also, have different Attitudes to Risk towards different objectives e.g. pension planning, savings, investments. If this is the case then the adviser will be expected to demonstrate this on the customer file.

Advisers will be expected to ensure they ascertain the customer's Attitude to Risk at a specific point in time and ensure they understand fully any risks inherent with the advice provided. A customer's Attitude to Risk may change over time and this aspect needs to be checked by the adviser at the time agreed for a review. The customer must be helped to understand how such a change will impact on any investment advice provided and the adviser will be expected to be able to demonstrate that the customer was made aware of the implications of any change in Attitude to Risk and associated advice at all times and in different market conditions.

Whilst it is expected that advisers gather as much information as possible, some people will not be willing to disclose everything. In this instance, advisers will need to make it very clear that any advice provided will be based on the information the customer is willing to provide and has provided. Part 2, Chapter 2, considered this scenario in more detail. Advisers will need to inform these customers that their recommendation will not take account of any information not disclosed, e.g. other investments the customer has, and as a result the customer may be over/under exposed as regards the appropriate overall risk profile of the customer.

Client Attitude to Risk was discussed in Part 2, Chapter 2, and advisers will often use scales to assess a client's Attitude to Risk. An example was shown in the fact-find template suggested in Part 2 Chapter 2. There are a number of ways of classifying a client's Attitude to Risk: in 1.4 above, we set out a basic three-way approach: Cautious, Balanced or Growth; the labels Safety, Balanced and Adventurous could also be used, but remember it is the nature of the underlying assets which determine investment risk. For some advisers, investors might alternatively be placed into one of the five following risk classes:

- **no risk** – they are not prepared to see any fall in the value of their investments
- **low risk** – they are prepared to accept some fluctuation in the value of their investments in return for long- term growth but will mainly invest in secure investments
- **medium risk** – they will have some cash or bond investment but will have a fair proportion in asset-based investments in a diversified investment scheme or share portfolio
- **medium-high risk** – they will be prepared to invest outside the UK and in high risk funds. Cash will be kept to the minimum and they may choose to sacrifice some diversification for a more focused and volatile portfolio
- **high risk** – they are prepared to have direct holdings in listed and unlisted shares, high risk funds and highly geared unprotected structured product. Cash will be kept to a minimum.

The classification of an investor's Attitude to Investment Risk has developed, particularly over the last couple of decades, as the financial regulator has offered guidance and encouragement for advisers to know their clients. Other advisers may use a grading from 1 to 10 to gauge how comfortable a client is with a specific type of risk. It is not unusual to see different classifications across the market involving a different number of risk classes. These classifications may be promulgated by industry bodies such as the ABI. Whatever, the principle is the same whatever classification is adopted and the objective of adviser and investor is to use whatever classification is being used to elicit the correct risk appetite for the investor for the type of investment under consideration and ensure that the underlying assets chosen for that investment match the investor's Attitude to Risk.

Whatever "scale" is used, by itself it will have limited meaning to clients. The client may also be unaware of the risk involved with a particular type of investment. But it will be the adviser's job to choose investments to suit the client's risk appetite.

Advisers will need to hold in depth discussions with each client to explain what the risk range means and how these numbers relate to risks that are real to them. The discussion will need to be extended to cover aspects, which can impact on Attitude to Risk, such as those immediately following (some of which we considered in our generic consideration of investment risks in the last Chapter) – but not limited to just these:

- capital security
- shortfall risk
- interest rate risk
- inflation risk
- regular income withdrawals
- charges
- penalty fees
- age
- family commitments
- the need for income and or growth
- whether there is an investment target
- the investment time horizon.

Attitude to Risk and Capacity for Loss

In January 2011, the FSA published guidance consultation on assessing risk (GC11/01) Assessing suitability: Establishing the risk a customer is willing and able to take in making a suitable investment selection. It commented that although most advisers and investment managers consider a client's Attitude to Risk when assessing the suitability of an investment, many fail to take appropriate account of their Capacity for Loss. The guidance recommended that "firms should ensure:

- 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
- any risk-profiling or asset allocation 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 all aspects of 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."

An adviser, in assessing a client's Capacity for Loss, should be objective. It may be necessary to override a client's subjective and perhaps over-optimistic view of his Capacity for Loss. In the event of a complaint some time after the original advice and investment, the FCA's view might be that an adviser should have steered a client away from a risky and now-failed investment notwithstanding the now-cash-strapped client's apparent willingness to accept the risk originally. A client's prerogative may be to be wise after the event. It is not the adviser's.

2.3 TIME HORIZONS

We discussed prioritisation of needs including time scales in the previous Part. Because clients may well have a particular time scale in mind as to when they wish to harvest the fruits of their investment contributions, it is worth reiterating, and expanding where appropriate, the points here.

Most clients can easily distinguish between their immediate needs and longer-term objectives, but achieving both can be very difficult. An immediate objective might be to pay off a loan (or reduce the mortgage, perhaps), while a longer-term objective might be to have sufficient capital and income to be able to retire at age 55. The adviser will need to recommend suitable investments to achieve the stated investment objectives: for example equity investments for the 20-year old until these investments are switched to less volatile investments in the five or ten years before his 55th birthday when his pension might be set up or cash taken. But not all clients will wish to cash in investments at 55: the adviser will need to allow for income requirements which might extend the time horizon on all or part of the investment fund.

Clients are much more likely to emphasise the immediate needs over the longer-term objectives. Advisers therefore need to balance these against the need for longer term planning, such as pensions which may require the sacrifice by the client of more immediate and tangible benefits.

The fact finding process will normally allow the adviser and client to identify a range of aims and objectives, which will then need to be prioritised. Objectives should, however, be revisited as circumstances change to ensure that they are still valid and on course. For example the 20-year old mentioned a couple of paragraphs ago may decide when he is 45 that he will retire at 60, adding five years to his investment horizon, and may perhaps set up drawdown or alternative income provision for non-pensions investments. This might add a couple of decades to his investment horizon!

2.4 STRATEGY

An investment strategy is established by applying an asset allocation that is based on the client's risk profile. For example, where the client's risk profile* indicates that he is reluctant to take too many risks the capital to be invested might be allocated to asset classes as mooted in the Cautious categorisation in 1.4 above:

- 15% in cash deposits or money market instruments
- 35~40% in fixed interest
- 10~15% in property
- 30~40% in equities.

** Note that this has not yet taken account of differences which can arise between the appropriate risk profiles for a client's capital and a client's pensions: they may be different and if so need to be addressed appropriately.*

But where the risk profile indicates that the client is much less risk-averse, the capital to be invested might be allocated to Growth asset classes as follows:

- 5% in cash deposits or money market instruments
- 15~25% in fixed interest
- 10~15% in property
- 55~65% in equities.

Asset allocation within the broad asset classes shown above, however, is only one means of controlling the risk- reward ratio. Depending on client's needs and indeed the investment portfolio approach chosen by advisory firms, the selection of investments within an asset class can also play an important role, e.g. Government bonds are less risky than emerging market bond funds; UK equities (for a UK investor) are less risky than Korean equities. The table below gives examples of the differential risk profiles of funds within two major asset classes. Bear in mind though that an equity income fund may still be more volatile than a strategic bond fund: Fixed Interest as an asset class is generally regarded as less risky than Equities as an asset class.

| | | |
|--------------------|---|--|
| Lower risk | Fixed Interest <ul style="list-style-type: none">• Gilt funds• Global Government bond funds• Investment grade corporate bond funds | Equities <ul style="list-style-type: none">• Equity income funds• Income and growth funds |
| Higher risk | <ul style="list-style-type: none">• Emerging market bond funds• High-yield bond funds• Strategic bond funds | <ul style="list-style-type: none">• Alpha funds• Smaller company funds• Specialist funds (e.g. technology) |

Advisers create or buy in model portfolios for each risk profile they use which show the percentage of capital to be invested in each of a set of funds. Portfolios created by modelling tools will vary depending on the assumptions and selection criteria used as inputs.

Where firms are using risk profiling/asset allocation tools, they should ensure this is adequately recorded on the customer file. However, even where such tools are used, firms should be mindful of the fact that it remains their responsibility to ensure their customers achieve the appropriate level of understanding and that the investments selected match the client's Attitude to Risk profile.

The FSA issued guidance consultation, back in 2011 for example (and of course the FCA's oversight on this is ongoing), expressing concern that some firms constructing portfolios for customers based on risk assessment and asset allocation planning tools are then getting the final risk profile wrong based on the use of managed funds. For example, a portfolio planning tool might indicate a customer should invest across the following asset groups to match their stated risk profile:

- 10% cash
- 10% corporate bonds
- 10% property
- 50% UK equities
- 10% European equities
- 5% Japanese equities
- 5% North America equities

An advising firm might commence portfolio construction by choosing the six smaller asset classes and then select UK equities with a "managed" fund offered by investment houses. Note that ABI requirements for the content of a UK Equity fund is that it contains at least 80% UK Equities: that means that 20% of the fund could be in other assets.) So, for the purposes of this example, suppose the adviser has selected funds based on his own experience of these funds, including a managed fund to make up the whole of the 50% UK equity sector. A problem arises where the underlying assets within this managed fund are constructed in the following way:

- 5% cash
- 5% corporate bonds
- 80% UK equities
- 10% US equities

In this example the overall exposure to American equities would actually be 10% (i.e. the original 5% together with this further 50% of 10%) and not the 5% dictated by the asset allocation tool. Even a fund called "Property" will have a small element of cash (if only from recently-received rent, ignoring proceeds from any sales or recent fund input being accumulated for investment) and particularly if the fund is relatively small the cash percentage could be significant. The suggested profile above allowed for 10% in corporate bonds. A Fixed Interest fund might seem to provide the solution. But Fixed Interest funds could have Gilts, bank and building society loan stock and emerging market debt as well as the desired corporate bonds. If the client then misses out on growth from corporate bonds picking up a loss from long-term Gilts instead, there could be grounds for a complaint. In practice the above profile is likely to target 10% Fixed Interest rather than 10% corporate bonds so there would not be an issue if that was agreed at outset.

All this demonstrates the need for advisers using these tools to fully understand the basis upon which funds are selected, to know what the funds contain and to make their customers aware of any mis-matches in the portfolio agreed at the outset and the final selection (and agree or adjust as appropriate). The process of asset allocation is increasingly complex as the above example where the adviser attempts to make the choice shows. Nowadays an analysis system is essential for any adviser providing advice on investments. The analysis system will take into account the actual sector content of the funds in an investment portfolio and show the precise percentage split, for the time being, of that investment. Frequently, advisory firms will now have analysis tools which pre-allocate specific funds for an investor in one of their risk categories. The adviser's task will be to ascertain inter alia the investor's risk appetite and then choose investments. Projecting forward, say one year, to the review point, the underlying investments will have changed in value and it is unlikely that they will match precisely the originally agreed percentages. At the review therefore, the investments can be rebased with the investor's agreement and the adviser's explanation. Furthermore, as allocation tools become increasingly sophisticated in X-raying actual asset splits, it may be that the investment profile chosen will be automatically rebased by the advisory firm or the platform used by that firm.

The student may wonder how all these different procedures can exist. Surely they cannot all be correct? It is worth reflecting on what will be occurring in these different scenarios. In each case the investor's requirements should have been established and the adviser should have explained what will be happening at inception and going forward. If the client, say High Net Worth, requires automatic rebasing then he should be using an adviser whose systems can deliver that and that will be reflected in the Client Agreement. If the client is less sophisticated and with just a few ISAs for investment then a more straightforward and less expensive advice profile could be more suitable. That too should be reflected in the Client Agreement. As far as the FCA is concerned, the outcomes for the client will be as the client expects. There is no rigidly-fixed approach which is "correct" as such. The correct outcome for the FCA will be what is in the client's interests and that will be agreed with the client and delivered through thoughtfully-constructed and carefully-delivered advice.

In using research tools, the adviser should bear in mind the nature of the data used. An adviser looking for a "balanced" fund might use an analysis tool to select a suitable fund which matches his client's risk. But what makes that particular fund "balanced"? Research, probably based on statistics over a five year period, might indicate the volatility of that fund matches a balanced profile. Or it may be decided that a fund rated by the ABI as Mixed Investment 40-85% Shares is ideally suited to a client for part of his investment. But what happens if the volatility of the fund changes? Or what happens if the new fund manager of the 40-85% fund changes its profile? Or merges the fund? Or simply chooses different stocks/shares for sound investment reasons? The point to bear in mind is that reviews, consistent with the Client Agreement, are essential not only to check on the client's circumstances but also to check on the investment's "circumstances".

Moving back to consider the nuts and bolts of the advice process, advisers should also take into account whether the client:

- will need access to his capital or an income from any investment
- has any political or ethical views when investing.

Many people have strong ethical reasons for including or excluding certain types of investment, and advisers should ensure that they are aware of any ethical, moral, religious or simply socially responsible beliefs of a client since that can heavily influence their choice of investment. A client's religious beliefs might involve investment in funds which comply with Islamic law i.e. Sharia compliant.

There are generally two approaches to socially responsible investment, positive screening and negative screening or avoidance:

- Positive screening involves investing in companies that have a responsible approach to business. These could be companies that have the best practices in their industry or it could be companies in a particular sector such as alternative/renewable energy sources.
- Negative screening or avoidance involves not investing in companies that do not meet the ethical criteria that the fund, selected for the client, sets. This usually focuses around ethical issues such as alcohol, tobacco and animal rights. Negative screening is central to Sharia-compliant funds: gambling, alcohol and pork products would be excluded investments.

It is a debatable what effect socially responsible ESG-investing has on investment returns. On the face of it, stipulating that investments should or should not be made, where the stipulation is made on non-financial grounds might suggest that the returns could be lower. But if a sufficient number of people lose interest in a stock because it is regarded as socially irresponsible then that must affect that stock's value adversely. Conversely interest in a stock for non-financial reasons could boost demand for that stock. Careful analysis is required by the adviser before recommending, with explanations and caveats, a course of action for a client who has ESG requirements.

As well as by selecting a less risky fund in its own right, risks can also be controlled by diversifying. This can involve splitting equity investments between UK equities and overseas equities and by investing in different sectors (the pharmaceutical sector or utilities, for example). Advisers can also achieve diversification by choosing fund managers who use different styles and methods. The effectiveness of diversification depends on the degree of correlation between the returns on investments in the portfolio. The most effective diversification comes from combining investments which are negatively correlated, i.e. where their values move in opposite directions to each other, but this is not always easy to find. In practice, therefore, investors may have to choose investments that are not correlated, i.e. where profits and share values are not related to each other, or where the correlation is as low as possible.

Asset allocation should also recognise whether the client is accumulating capital or whether the client is drawing from that capital. That element of assets from which the client needs to draw income/capital should be in low risk investments (unless perhaps the client is satisfied to draw down natural income, i.e. dividends, from previously-selected income-yielding assets.).

Where the client is accumulating assets over the long-term, he can take advantage of £ cost averaging through regular purchases. This advantage arises on the premise that asset prices increase over the long term, so that purchases made in the earlier years will have been made at prices lower than the latest price. Also, if returns do fall short of those expected, the long-term investor usually has time for any shortfall to be made good.

Where a client is looking to draw capital from the investments, i.e. decumulate, it is not just the initial yield on investment that is important. Consideration should also be given to the overall rate of income generated, the likely level of inflation and interest rates, and the probable rate of growth in company dividends. Where a client wishes to withdraw more income than can reasonably be assumed to be sustainable, it might be legitimate to adopt a higher-risk investment strategy. But the client must be made aware of the erosion-of-capital risk involved.

Once the asset allocation, matching the client's Attitude to Risk and Capacity for Loss, has been agreed, the adviser can then look to recommend allocation of the capital to a combination of accounts with different tax treatments, depending on which gives the most favourable tax treatment. Tax wrappers are structures for holding investments that are taxed in different ways and may be subject to other restrictions. The main tax wrappers are: collectives; individual savings accounts; UK life assurance policies; offshore life assurance policies; registered pension funds. These products were discussed in more detail in Part 3 of the Taxation, Retail Investment and Pensions module.

2.5 PERFORMANCE

Once the financial plan has been finalised, the adviser will arrange for its implementation.

Where the plan involves investments, the client and adviser should agree a plan of monitoring performance (see 3.3) and rebalancing investments if, or rather when, this becomes necessary (see 3.4.2).

2.6 PROMOTION OF SCHEMES THROUGH EMPLOYERS

We considered the needs of employees when saving for retirement and employee engagement in Part 1 of the Taxation, Retail Investment and Pensions study manual. The student may wish to refer back to this

From the Retail Advice perspective, an adviser can productively work with an employer in the promotion of new, replacement or amended schemes. The extent of adviser involvement will depend on the employer's requirements.

While there are no restrictions preventing employers from promoting occupational pension schemes to their employees, employers answering their employees' questions should bear in mind that they may not know the detail of an individual's financial circumstances or their expectations for the future. The individual may not wish to give certain personal information to an employer.

Most importantly the provision of financial advice by someone who is not authorised is likely to be illegal. Employers should not give personalised advice, even if they genuinely want to help. Formal advice sessions can be arranged with an adviser, probably remunerated by fees paid by the employer.

Summary

This Chapter looked at the concept of know your client and asset allocation. This included looking at the client's goals and Attitude to Risk, and putting this in the context of the time horizons for delivering the plan. It also considered the basics of investment strategy and performance.

Self Test Questions

- What are the five risk classes that investors might fall into?
- Describe the process of understanding a client's goals as they relate to investments.
- What should an analysis of a client's Attitude to Risk consider?
- What should an investment strategy cover?
- When can an employer provide personalised financial advice?

CHAPTER 3

Investment Planning and Performance Monitoring

INTRODUCTION

Put the clock back to the middle of the 20th century and investment planning for most people was deciding whether or not a non-profit or with-profit insurance policy was the best solution if a bank or building society account was not the answer. Then, should it be a lump sum? Or a regular premium policy to get the benefit of Life Assurance Premium Relief? Those were the days when you could get partial tax relief on regular long-term life assurance premiums! Finally you would decide whether you wanted the Refuge to come round and collect your premiums in cash each week. Or did you prefer to pay by cheque at the local Royal branch. Few people used stockbrokers and there were only a very limited number of unit-linked insurers with whom you could invest. For those who did invest in shares, their stockbrokers would probably recommend a selection of FT30 shares (no “Footsie” then) based on their research and knowledge of those shares.

It was around the middle of the 20th century, March 1952 to be precise, that Harry Markowitz published his paper, “Portfolio Selection” (we considered his contribution to Investment Theory above). He developed his ideas during the 1950s. Others contributed to the debate and gradually what was to become known as Modern Portfolio Theory (MPT) emerged. In essence MPT postulates that the assets in an investment portfolio should not be selected individually rather consideration should be given to how each asset changes in price relative to the price change of other assets. Under MPT, investing is a tradeoff between risk and expected return noting that assets with higher expected returns are riskier. For a chosen level of risk, MPT shows how to select a portfolio with the highest possible expected return. Or, for a given targeted return, MPT explains how to select a portfolio with the lowest possible risk (shown as an “efficient frontier” in many 21st century analyses). In essence MPT is a form of diversification where MPT, given certain assumptions for risk and return, explains how to develop a robust diversification strategy.

MPT has been widely developed and criticized over the last 60 years. But it underpins many of the underlying elements of today’s investment planning.

There are a number of elements which fall within the concept of investment planning and performance monitoring. In this Chapter we will describe how a portfolio is constructed for a client and then look at how its performance is monitored and reviewed.

The Chapter will also describe wraps and other investment platforms.

3.1 ASSET ALLOCATION STRUCTURES

Having established a client’s Attitude to Investment Risk, and Capacity for Loss, for the investment being discussed, the financial adviser can create a suitable investment portfolio. As discussed in the previous Chapter, before a portfolio is constructed the asset allocation has to be agreed. The asset allocation used will be based on the client’s risk profile and generally takes advantage of the benefits of diversification. As such it is therefore essentially defensive, placing capital protection before capital growth. By way of contrast, and to give perspective, consider the approach of an entrepreneur who sinks all the capital he has, plus perhaps capital he does not have (a loan), into one undertaking: he may become very wealthy or he may end up bankrupt. Asset allocation giving diversification is the usual way in which an adviser will help his client. Structures for applying the agreed asset allocation are now considered below.

3.1.1 Strategic and Tactical Asset Allocation

The primary aim of asset allocation is to use the client's risk profile to determine a suitable long-term strategic asset allocation for that client. This will determine what percentage of the client's capital should be invested in each asset class. Periodically the portfolio will need to be rebalanced in order to maintain the long-term goal for asset allocation.

Strategic asset allocation is for the long term and is usually only adjusted in extreme conditions or if the client's requirements or circumstances change.

Some advisers, however, employ tactical asset allocation by having asset allocation models that give a range of the percentage of capital in each asset class. So if for an agreed tactical asset allocation, it is decided that Equities should represent 45% to 75% of the portfolio, the advisers, or investment managers acting for them, will be able to take advantage of these investments if they are expected to perform well. This discretionary latitude might be expressed as allowing the percentage of Equity investments to change within a range band of say 10% to 15% around the mid-point (60% in the above example). When Equities (in this example) are expected to perform well the assets in this class could be held at the top of the range band, reducing the assets held in other classes to the lower end of their range. The tactical move from the mid-point of the range may be permitted on a short-term basis. The following table shows how this might work in practice.

Strategic and tactical asset allocation

| Asset class | Strategic range | Tactical allocation | Variation from mid-point |
|-------------|-----------------|---------------------|--------------------------|
| Cash | 10%-20% | 10% | -5% |
| Bonds | 10%-40% | 20% | -5% |
| Equities | 45%-75% | 70% | +10% |
| Total | 100% | 100% | |

3.1.2 Stochastic Modelling

Stochastic modelling is used to predict returns based on anticipated market movements. It is a statistical process that uses probability and random variables to predict a range of probable investment performances. Based on information the client provides about age, investments and risk tolerance, financial analysts can use stochastic modelling to help evaluate the probability that an investment portfolio will allow the client to meet his financial goals.

It is used to estimate the probable outcomes within a forecast under different situations. The random variables are usually constrained by historical data, such as past market returns. Multiple simulations of the performance of the portfolio are done based on the probability distributions of the individual stock returns. A statistical analysis of the results can then help determine the probability that the portfolio will provide the desired performance.

The technique produces a probability distribution which can be used to produce a pictorial illustration of the range of possible outcomes, with the most probable outcomes clustered together and the less probable at the extremes.

3.2 PORTFOLIO CONSTRUCTION AND FUND MANAGEMENT STYLES

The aim of portfolio construction (once client investment objectives have been determined) is to achieve diversification principally by sector and geographical location on the basis that this will reduce risk. In practice this has normally followed a top-down process as follows:

- determine asset allocation
- allocate the geographical distribution
- choose the sector weightings
- stock and fund selection.

Often portfolios that are constructed in this way will be designed to match a specific benchmark and any deviation from that benchmark will represent a risk to the manager in that it could see the portfolio either outperforming or underperforming against the benchmarked index. Portfolios which diverge significantly from

index benchmarks will typically display greater short-term volatility. The risk inherent in this short-term volatility needs to be weighed against any potential long-term outperformance against the specific benchmark.

A different approach for portfolio construction, the above approach being top-down, is for the adviser/manager to ignore benchmarks and invest from the bottom-up applying their own criteria. We consider such criteria in the next section.

3.2.1 Fund Management Styles

Different fund management styles exist where stock selection and management are based on a selected set of principles.

While each fund manager will try to convince investors and advisers that their style is unique, management styles can be split into two main themes: active and passive. The active fund manager will pursue a stated goal such as “deriving income from UK SMEs with potential for capital growth”. The passive fund manager’s goal may be, for example, to “match the FTSE100 before charges”. Trading in underlying investments is more frequent in active funds than passive and as a consequence fees charged can be expected to be higher on active funds. The active fund manager will hope that his investment performance will be better than a comparable passive fund (e.g. an active UK equity fund cf. a passive FTSE100 fund), but there is no guarantee. The performance of the active fund may be worse if poor investment decisions are made. The adviser’s task in all of this is to establish his client’s Attitude to Risk, choose funds and management styles to match and explain the risks involved. The choice to use an active fund will probably be determined by the reputation of the fund manager/management team while the choice to use a passive fund will be largely dictated by the availability of a suitable Index.

There is often debate as to which main theme is best. The advantages of both could be summarised as follows:

Advantages of active funds

- Managers have greater investment flexibility and can choose specific regions, sectors or companies.
- Provides the opportunity to generate an income, preserve capital and protect against inflation.
- Provides the opportunity to obtain better returns than an Index.
- Clients should have greater choice of investments, not limited to a particular Index allowing them to invest in a fund that best suits their needs.
- Investments can be made in anticipation of possible future developments.
- Provides the chance to avoid market falls when the chosen Index is adversely affected.
- Provides the opportunity to achieve less volatile returns.

Advantages of passive funds

- Usually cheaper BUT a more expensively charged passive fund will have higher charges than a competitively charged active fund.
- Tend to be straightforward and easier to understand, especially with regard to the fund's investment policy e.g. following the FTSE100 rather than wondering which FTSE100 shares the active fund manager has chosen for the time-being.
- Easier to maintain and review.

Passively managed funds

As indicated above, passive fund managers attempt to replicate the performance of an index representing a chosen asset class. There are two key aspects to passive fund selection: index selection and structure.

For most asset classes there are several indices available. In some cases the differences are slight, but in others they can be more significant. This is particularly the case for specialist asset classes such as high-yield bonds or private equity, where the choice of index is critical and the adviser needs to understand the index methodology.

Passive funds may take the form of investment trusts, OEICs or Exchange Traded Funds (ETFs). ETFs may be "physical", i.e. they hold stocks to replicate the index, or they may be "synthetic", i.e. they use derivatives to match the index. Advisers need to understand the advantages and disadvantages of these structures.

To restate the point made a few paragraphs earlier, passive funds tend to have lower AMCs than actively managed funds. Their performance may or may not be higher or lower than active funds investing in a similar market. The comparative performance of these funds, as with any other funds, is a factor the adviser needs to consider for his client, along with the volatility inherent in each fund.

Actively managed funds

Before considering popular types of active investment styles it is worthwhile re-considering the terms "alpha" and "beta" which are often met with in investment circles. Strictly speaking they are investment measurement tools emerging from Modern Portfolio Theory.

Alpha is the differential return, the positive or negative excess, of an investment relative to the return of a benchmark index. A positive alpha of 1.0 means the investment has outperformed its benchmark index by (plus) 1% while a negative alpha of the same value means an underperformance of minus 1%. Investment managers, when talking about "delivering alpha", are seeking the positive outperformance.

Beta measures the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. A "beta" of less than 1 indicates that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market. For example, if a stock's beta is 1.1, it is in theory 10% more volatile than the market.

Put another way: alpha managers try to select individual financial assets (stock, fixed income, even private companies) that will outperform their benchmark while beta managers select securities in relation to a target level of risk.

Active fund managers, whether seeking alpha or beta, adopt different approaches for their chosen investment style. They include the styles described below.

But before we consider active fund manager styles, bear in mind that some investors will simply “*Buy and Hold*”. If that means holding shares in their own established company that is immediately understandable. But investors may well have specific reasons for holding an asset: the fact-find should establish both the asset and any overriding reasons for continuing to hold, which reasons may have little to do with normal investment growth optimisation: *Diversification* strategies have already been discussed above and should also be considered by the adviser.

So what active fund investment management styles are there?

Value – essentially value investing involves buying securities which are believed to be underpriced. Value strategies involve investing in stocks that have low prices relative to some measure of fundamental value, such as the book value of equity, dividends, earnings or cash flow. Many investment fund managers will meet up with the Board of the company in which they are investing or planning to invest. This can be either in the UK or in any country where the investment manager believes value can be obtained for investors. The investment manager’s analysis seeks to identify shares whose intrinsic value (in their opinion) is greater than the price placed on them by the market. By buying and holding those shares, managers hope to earn a higher return than the market average. Value strategies are linked to the idea that markets overreact to new information, so that investors benefit from investing in those stocks that have done badly in the past. The strategies will also seek to benefit from entrepreneurial activities. Whatever the investment, the Value investment manager will have agreed in-house that the chosen investment will generally be made for a certain term or until certain profits have been achieved. Managers of “equity income” or “income and growth” funds often adopt this style. Value investment managers are “looking for alpha” and when they find it, whether by good judgement or by good fortune, they will advertise the superiority of their investment style over Buy and Hold, Passive etc. The adviser needs to place such claims in context.

Momentum – Momentum investment managers aim to identify sectors which are expected to perform well at particular points in the economic cycle as it uses the theory that in equity markets there is a small tendency for both good (and bad) performance to persist. In contrast to many Value investing styles, Momentum strategies involve investing in those stocks which have done well in the recent past. Momentum fund managers will unashamedly follow the crowd on the basis that other investors’ interest and demand will drive up prices. Momentum managers will then expect to use their skills, insight and general market research to sell (or buy) just before sentiment swings. Momentum trading is often transacted on a short-term basis, often less than a day if the manager believes he has correctly determined both the buy and sell points. Like Value strategies, Momentum strategies have been shown to provide returns that are superior to those of a simple Buy-and-Hold strategy.

Contrarianism – also known as contra-cyclical or counter-cyclical, contrarian fund managers theorise that the average opinion is usually wrong and that higher returns can be achieved by going against the trend. This style is most often found in hedge fund managers. A contrarian manager will buy when a share is performing poorly - not on the basis that it is performing poorly but because he believes that the share’s next movements will be positive; he will sell when the asset is performing well on the basis that it is near its peak and can only go down. Managers of many Recovery funds are good examples of the success of contrarian investors. One well-respected manager, still successfully managing today, bucked the trend some twenty years ago by shunning technology stocks, even though the market was all in favour of such stocks, and by buying tobacco stocks, which were very much unfashionable at the time. Another spent his career with one company and built up from 1979 an enviable reputation and a £6 billion fund with his contra-cyclical ideas. The fund was so large it was decided in 2006 to split the management of its investments while the original architect moved to pastures new..

3.2.2 Fund Selection

The main criteria which are used by advisers in fund selection and which we will look at in this section are:

- fund objective
- costs and charges
- strength and reputation of the management group
- skill and reputation of the fund manager
- type and structure of fund
- performance.

Fund objective

The Investment Association (IA), formerly the Investment Management Association (and also known under other names, since its foundation in 1959 as The Association of Unit Trust Managers, following subsequent mergers with other organisations), helpfully divides funds into sectors which split around 3,000 of the various funds on sale in the UK into broad groups. Each sector sets out the criteria that funds must follow if they elect to belong to that sector, and most are organised around the principal asset types in which the fund should invest. For example, the UK All Companies sector comprises “Funds which invest at least 80% of their assets in UK equities which have a primary objective of achieving capital growth.” The IA identify around 30 investment sectors. Funds are also split broadly between those that aim to produce income and those that aim for capital growth. These are further classified based on the type of asset, region or industry sector in which they invest. A few sectors are focused on capital protection, such as money market funds, or are in the specialist category. The risk-return characteristics of each fund should vary depending on the sector which a fund is in.

The Association of British Insurers (ABI) produces a comparable classification: “ABI Sectors”. As they say in their literature (last updated September 2016): “The ABI Sectors is a system for the classification of life and pension funds. Every sector sets clear criteria that must be followed by funds wishing to belong to that sector. We introduced the ABI Sectors in 1997 to ensure that life and pensions funds operating similar investment strategies are grouped together, so that consumers and financial advisers can compare them on a like-for-like basis. The ABI Sectors contain over 8,000 life and pension investment funds, representing over £700 billion in assets under management”.

Generally, therefore, the first stage in fund selection is to identify funds with similar objectives. The tools provided by the ABI, IA or others assist in this.

Costs and charges

The FCA has increasingly insisted that all charges are transparent. RDR required charges to be disclosed more clearly and in writing. The FCA 2017/18 Business Plan included the following as one of the outcomes the FCA is seeking: “Requiring clearer communication of fund charges and their impact to retail investors, both at the point of sale and in ongoing communication.”

Note also that the FCA have insisted from 6 April 2015, that firms providing workplace pension schemes used by employers for automatic enrolment will have to cap the charges within default funds to 0.75% per year of funds under management.

In addition to the basic charge which the fund manager retains (perhaps funding adviser remuneration out of this), share registration fees, fees payable to auditors, legal fees and custodian charges all need to be met to give the overall costs.

The main charges applied by UK-authorised funds are:

- The Annual Management Charge (AMC). This is applied as a percentage of the assets under management. For passive funds this is normally in the range 0.20% to 0.75% and for actively managed funds from 0.75% to 1.75%. The AMC is levied by the manager and is used to pay the investment manager, financial adviser, fund accountant, administrator and distributor.
- The Total Expense Ratio (TER) adds together all ongoing charges (but not any initial or exit charges or, generally, performance fees) and expresses them as a percentage of the assets under management. The term Ongoing Charges Figure (OCF) is increasingly used particularly where UCITS are involved. The principal element of TER is the AMC, but managers are permitted to charge certain additional expenses to the fund. TERs are typically 0.25% to 0.50% higher than AMCs. Many permitted costs are monetary amounts rather than percentages, so TERs are often lower for larger funds. All payments to the investment manager, financial adviser, fund accountant, administrator and distributor (former being AMC components) plus other operating costs for extra services paid for by the fund, such as the fees paid to the trustee (or depositary), auditor and regulator any delegates of the foregoing are included in the TER/OCF. The FCA expect (see TR14/7) the TER/OCF to become the headline charge figure.
- Performance fees may apply to the incremental performance above a set threshold, which will be linked to a benchmark index.

Other costs (some of them are for older-style investments) that investors incur in funds are:

- Entry Charge – this is a charge made when a fund is set up, but many managers offer funds at no initial charge or significantly reduced charges via platform supermarkets and wraps (see 2.5 below). There are other variants on entry charges. Older contracts set up before the 1990s are likely to have Initial Units where the first two years' worth of premiums was used to purchase Initial Units bearing a higher AMC throughout (most of) the life of the contract. These Initial Units generally persisted for the normal duration of the contract. Both initial charges and the less transparent Initial Units aimed to recoup initial expenses. Allocation Percentages were also used: this device involved deducting a percentage of the initial investment, including lump sum investments where the term to maturity was short e.g. an insurer might allocate only 98% of an investment to a pension policy where the term to selected retirement date was less than five years.
- Exit Charge – this may be charged when an investor redeems units provided it has been explained at the time of purchase. It would be unusual to see an Exit Charge if an Initial Charge has been levied at outset. An Exit Charges cap of 1% on existing personal and occupational pensions and 0% on new contracts was announced by FCA and the DWP – TPR will be involved for trust-based schemes – in November 2016 to facilitate pensions freedom.
- Bid-offer spread – dual priced funds, such as unit trusts, quote two prices and the spread between the two represents the cost to the investor. The creation price of units or shares is usually higher than the redemption price. Bid-ask (another descriptor for bid-offer) spreads are a way of recouping initial charges. A further variation on this theme was an Establishment Charge where a higher AMC was taken for the first, say, three years in the life of a contract. OEICs are generally single-priced. Funds sold nowadays are unlikely to have bid-offer spreads: this is consistent with the FCA's wish for transparency under RDR.
- Dilution Levy – fund managers may use dilution levies in conjunction with single-priced units to directly recoup trading costs or use a "swinging single pricing", a method of single pricing in which the unit price is adjusted in order to protect the fund a dilution adjustment is made to the unit price, to include the actual dealing spread and the notional costs of dealing
- Stamp Duty Reserve Tax – UK authorised funds incurred stamp duty on UK shares at a rate of 0.5%. This was abolished from 30 March 2014 for collective investment schemes, the Government wishing to make the UK a more attractive domicile for OEICs managers.

- Portfolio Turnover Rate (PTR) – each purchase and sale incurs transaction costs, and the higher the PTR, the greater the cost incurred by investors. A few funds have low PTRs of 20% or less but the majority fall in the 50% to 100% range, with highly active funds incurring higher rates. The actual costs are highest for equity funds since transaction costs in bonds and derivatives are generally lower, although the bid-ask spreads in bonds may be higher than for blue chip equities. The COLL section of the FCA Handbook (reflecting the requirements of the EU Commission Recommendation 2004/384/EC), makes mandatory the inclusion of the PTR in the simplified prospectus issued by fund managers. The rate must be calculated according to a prescribed formula.

Initial Units and bid-offer spreads are now largely historical as the FCA has regulated against front-end loaded contracts. But they are relevant in the advice process and will remain so for some years to come until the contracts bearing such charges reach maturity or are surrendered. Advisers will therefore require an understanding of past contracts, particularly pensions contracts which if set up, say, for a 30 year old in 1985 could still be extant at the end of this decade. Advice regarding retirement or transfers requires the adviser to understand both past and present charging structures.

A question which a student who is new to financial services may have is: “Why are charging structures so complex and varied?” Long before financial services regulation started, way back in the days of with profit and non-profit contracts, the charging structure of most life and pension contracts was very simple (though not necessarily fair to the consumer): the insurer took out the charges which its Actuary deemed appropriate. The insurer paid commission to the intermediary and declared bonuses on with-profits contracts: charges were implicit. But types of investment and insurance contracts have proliferated significantly, particularly from the 1970s since when the industry has tried many different approaches to charging. The impetus for making charges more explicit pre-dates regulation. Competitive forces precipitated the introduction of separate charging structures as insurers introduced unit-linked contracts and the historical charging structures (initial charges and bid-offer spreads) mentioned above were introduced. The position becomes even more complex when the fees or other remuneration of an adviser are taken into account. Is that paid for out of the charges? Is it an additional amount? An amount agreed with the adviser? When provider charges are declared are they confined to AMCs? Or TERs? And is the adviser fee included? Is a charge of say 1.75% inclusive of all charges, including inter alia platform and adviser fees i.e. “bundled” (where the 1.75% is an amalgam of 0.90% for provider, 0.10% for stamp duty, custodian fees and other disbursements, 0.25% for platform and 0.50% trail fee)? Or are the charges “unbundled” where the provider’s/fund manager’s charges are shown separately from the platform or adviser charge? Some providers will talk in terms of clean or superclean, in essence aiming at describing the unbundled principle. It is because of these complexities that the FCA seeks to move to transparency (a prime objective of RDR) and simplification in charging structures: Thematic Review TR14/7 encouraged more clarity and simplification of charges for the consumer. Like so many other aspects of financial services, the charges area is continuing to evolve: the adviser will need to understand what charges apply to the investments with which he is dealing. The student may have his/her own thoughts: given that your career is developing, you may well be able to find opportunities to contribute to the debate. But, even if not, you will need to understand its development and be able to allow fully for charges in your explanations to your clients.

Strength and reputation

The financial strength of a fund management group has implications for investors. Weakly capitalised or over-indebted groups could have difficulty in retaining quality investment managers. Their cash flow, derived from management charges which will be closely linked to the amount of funds under management, will be susceptible to changes in market values which could affect the viability of small groups. Larger groups with substantial assets under management will be better able to sustain themselves with the cash flow from their AMCs during a severe market downturn. In consequence new fund management groups find it difficult to establish themselves. The fund selection processes of many IFAs tend to exclude new fund management groups until they have been able to build a good reputation, by hard work and perhaps good fortune, or by the recruitment of a successful manager from an existing group.

Reputation is not only based on performance, but also on consistency of strategy. Groups that opportunistically launch fashionable funds (e.g. technology funds in the early 1990s) in order to attract assets under management are likely to suffer reputational damage.

Where a group is offering actively managed funds, the skills of one or more key managers could have a considerable impact on the performance of a fund and, therefore, the group's reputation. Some investment groups will argue that their success is due not so much to their manager but to the investment analysis systems, procedures and checks they have in place. For most investors however, the longer a successful manager stays in place, the better. Advisers may also take the view that the manager is very important to the performance of the fund and if the manager leaves the adviser may recommend a sale of the fund or a move to a different fund within the group. Alternatively an advising firm may decide to place that fund "on hold" (no new purchase made) until the replacement manager has established himself and they have discussed with him his strategy.

Type and structure of fund

Certain types of fund may be more or less suitable for investment portfolios depending on the client's risk profile. Among the relevant factors are:

- open-ended (where new units can easily be created) or closed-ended (where there is a fixed amount of shares in issue) – open-ended funds which always trade at Net Asset Value (NAV) are less volatile than closed-ended funds where a fluctuating premium on or discount to NAV can apply depending on the demand, or lack of, for that closed-ended fund
- gearing or leverage – many closed-ended funds have borrowings, which potentially add to returns but also increase volatility. The rationale for borrowing is that the fund manager believes he can make more money in the market than he has to pay for the borrowings. And that will be the case if his judgment is correct. If his judgment is wrong, then the value of the shares in close-ended investment company will fall, perhaps significantly
- UCITS – UK authorised firms may choose to adopt the UCITS (Undertakings for Collective investments in Transferable Securities) directive powers, which widens the range of methods that may be used particularly in relation to derivatives. These powers may be used to augment or diminish volatility. (More volatile investments are accessible through NURS and QIS, though the DRRRA student will not meet with these frequently and will not be expected to know about them for the purposes of this unit.)
- multi-manager or fund of funds – these funds assemble portfolios of funds, reducing the adviser's work in fund selection. Fund of funds portfolios may be narrow (e.g. UK equities, European equities), global or risk- rated (e.g. cautious, growth).

Performance

Performance measurement (refer also to Chapter 1 in this Part) has become more sophisticated in recent years with the availability of a range of tools and services employing statistical analysis. Simple performance analysis consists of looking at actual total returns and volatility over cumulative and discrete periods, comparing a fund with its benchmark index, sector index and possibly a small peer group of funds sharing common strategies and aims. Sophisticated performance analysis takes monthly returns and volatility and subjects them to analysis using a number of ratios, whose general aim is to reveal whether a manager's decisions are adding value. We consider this performance aspect in more detail in section 3.3 below.

3.2.3 Tax and Product Wrappers

The decision about which tax and product wrapper to use should take into account the client's individual tax and financial circumstances. The main wrappers to consider are:

- collective investments, e.g. OEICs and unit trusts
- ISAs
- personal pensions
- UK life assurance bonds
- offshore life assurance bonds.

Clients who pay 40% or 45% tax on their investment income will gain relatively more from tax relief on their pensions and ISAs than basic rate tax payers. Investors who regularly pay CGT because of the size of their portfolios may gain relatively more from wrappers that provide tax free roll-up of gains (but careful use of the CGT annual allowance can still benefit such investors).

Any extra costs, complexity or inflexibility should also be taken into account. ISAs often involve little or no extra cost, are simple and flexible, but cannot be held in a trust, whereas pensions may require additional fees to be paid, are complex and access to the funds is restricted, though significantly less so following the introduction of full access from the age of 55 after 5 April 2015.

Collective investments

Most clients are likely to find that collective investment funds are the most tax efficient and simple way to hold equity based investments. Investors buy collective investments and hold them in their own name (and as we consider below collective investments can be held in other tax wrappers.) Dividends are taxable when distributed to the individual investor at the investor's relevant tax rate. (Prior to April 2016 dividend payments were made net of tax with an accompanying tax credit.). Gains are subject to CGT payable by the individual investor when the units or shares are disposed of rather than when individual securities within the fund are sold.

Individual Savings Accounts

ISAs can hold collective investments or direct investments in shares, fixed interest securities or cash. The income and capital gains are tax free, although the tax credits on dividends cannot be reclaimed. The main advantage of

ISAs is that it is not necessary to make a return of the income or gains to HMRC, but the annual limits that apply to ISA investments may mean that it takes a number of years to transfer investors' wealth into this tax wrapper. Once sold by the investor, the ISAs cannot be placed back into the privileged tax wrapper (although current tax year repurchase following sale is now allowed up to the annual limit). ISA variants are considered in the Taxation, Retail Investment and Pensions unit.

Personal pensions

The main issue with investing in a personal pension or self-invested personal pension (SIPP) is whether the tax advantages compensate for the costs, inflexibility and complexity of investing in a pension arrangement. Important criteria in choosing a personal pension or SIPP provider include the efficiency of the administration systems and flexibility of the contract. Many clients will also have benefits within group personal pensions schemes (or occupational money purchase pensions schemes). Group personal (or occupational) pensions will increasingly be met with as the impact of automatic enrolment increases. The terms of group pension schemes, following the impetus given to charges reduction when stakeholder pensions (which were grafted onto the personal pension model) were introduced in 2001 and following the requirement for employer contributions, should significantly improve the value of personal pensions for the great majority of clients. The scope for selecting investments on behalf of clients with these investments is considerable and while the fund choice in group schemes may be limited the choice should not be overlooked.

UK life assurance bonds

The underlying fund in a UK life assurance bond is subject to UK tax rates that are similar to those paid by basic rate tax payers, but the funds do suffer a deduction for tax on capital gains. These are relatively more attractive to higher or additional rate taxpayers where the underlying investments generate income rather than growth and the tax deferral characteristics of the bond can be maximised if it can be arranged for the investor to be a basic rate taxpayer in the year of encashment. Also, it is possible to gift bonds to trustees or other individuals without triggering a tax charge within the bond itself – though there could be IHT implications.

Offshore life assurance bonds

Offshore bonds have many of the same characteristics of UK bonds, though charges are likely to be higher. The main difference is that the fund is not subject to UK tax and so should grow faster than the equivalent UK life fund. However, this growth will be reduced by the tax paid at encashment. Offshore bonds, therefore, tend to be worthwhile for those who can reasonably expect to be non-taxpayer, e.g. by becoming non-resident or by being able to use personal tax allowances, at encashment.

3.2.4 Provider Selection

When advisers are selecting UK providers of regulated investment products, the regulatory and supervisory framework helps to reduce the risk to their capital from theft or fraud. However, there have been instances where losses have occurred despite apparently strong institutional backing. Advisers need to check the financial rating of providers and if the ratings agencies give poor reports then weaker providers especially for long-term contracts should be avoided if there is a stronger provider able to provide an equivalent product.

However failures of providers or counter-parties (e.g. Equitable Life, the Icelandic bank collapses and Lehman Brothers) do occur so advisers should consider what would happen to a client's money if the fund manager became insolvent. This often boils down to the way in which assets are held. In the case of authorised funds, assets are held by independent custodians, so there is no risk if the fund manager fails. But if funds are held through a third party, such as a supermarket or wrap, then the adviser should, as part of his due diligence, ensure that as far as possible the third party provider has insulated clients from any adverse consequences should the provider have financial difficulties.

In considering the stability of providers a factor to bear in mind is the safety net provided by the Financial Services Compensation Scheme (refer to Part 1 of this manual, section 1.12). The FSCS, an independent body, set up under FSMA, is the UK's statutory fund of last resort for customers of financial services firms. The FSCS is funded by levies on firms authorised by the PRA and the FCA, which enables the FSCS to meet its running expenses and pay compensation to consumers if a financial services firm is unable, or likely to be unable, to pay claims against it. Where possible therefore in constructing a portfolio, an adviser should limit investments in any one provider (or group if there are subsidiary investment companies) to the FSCS limit.

3.2.5 Recommendations and Suitability

Advisers using asset allocation methods must include in their recommendations reference to the client's risk profile and other circumstances and how the target asset allocation and recommended portfolio may be achieved. This will focus on timescales, returns and risk. It should also indicate the range of expected returns and volatility over the given timeframe, with appropriate caveats about circumstances in which these expectations might not be met. The adviser should cover the following (with regard to fund selection aspects of his advice):

- the method of selecting funds within the various asset classes, including the reasons for using active or passive funds, open or closed funds or fund of funds in each category
- summaries of the most important features of the funds recommended (with fund fact sheets provided in an appendix to the Suitability Report)
- explanation of the choice of tax wrappers and/or wrap
- the frequency of review and the basis of ongoing advice and recommendations
- the cost of the service, both initial and ongoing.

3.3 PORTFOLIO PERFORMANCE

In looking at the performance of a portfolio it is necessary to differentiate between performance measurement and performance evaluation. Performance measurement involves calculating the investment return over a stated period. Performance evaluation is concerned with determining whether the investment manager added value by meeting or outperforming a suitable benchmark and how he achieved the calculated return.

There are two ways to measure investment returns:

- the money weighted return which allows investors to determine the overall return on the capital over a specific period;
- the time weighted return which measures the performance of the portfolio regardless of the capital invested and so can be used to compare the performance of one fund manager with another. Using a time weighted return eliminates the distortions caused by new money being added to a portfolio.

We will look in more detail at both the money-weighted return and the time-weighted return in the following sections.

Whether a portfolio manager achieves a good or bad result will depend on how he deals with the following:

- asset allocation
- stock selection
- market timing, i.e. deciding on when to introduce or withdraw funds from the market
- risk.

In performance evaluation it is necessary to show the separate contribution of each of these elements. Each element needs to be measured against an appropriate benchmark which will show how the manager's approach deviates from the benchmark and the effect it has had on the return.

3.3.1 Money Weighted Rate of Return

A money weighted rate of return can be used to calculate investment performance for a portfolio. It allows the investor to determine the rate of return during a selected period of time for which his capital has been invested. The return on the portfolio is the difference in the value of the portfolio at the end compared with the value at the start of the period adjusted for any income or capital distributions made from the portfolio during that period.

To calculate this return we need to take account of the following variables: I being initial investment
D being dividend or interest paid out, plus any withdrawals made
V being value at end of period
N being new investments added during the period.

Let the return we wish to calculate equal R_m .

$$R_m = \frac{V - (I - D + N)}{(I - D + N)} \quad \text{where } R_m, \text{ when calculated, should be expressed as percentage.}$$

Worked Example:

Assume: £50,000 is the initial investment
£500 dividends are paid out (or withdrawals made)
£750 new money is added
£55,000 is value at end of period

Using,

$$RM = \frac{V - (I - D + N)}{(I - D + N)} \quad \text{the formula can be evaluated:}$$

$$RM = \frac{55000 - (50000 - 500 + 750)}{(50000 - 500 + 750)}$$

$$RM = \frac{55000 - 50250}{50250}$$

$$RM = 0.094527 \text{ which is } 9.45\%.$$

This example is a simplified version: additional allowance would be made for the dates withdrawals are made and new monies added by proportioning the amounts over the period. But by using this simplified version the student will be able to appreciate better that while the return of 9.45% is a measure of how the portfolio has changed in value, it gives very little information about the performance of the investment manager. It has been distorted by the inflows and outflows (and we have not considered the actual timings in the Example). Nor have we considered the effect of the payment of new money and any withdrawals (no withdrawals in this example other than dividend) both of which are decided by the investor and not the manager. The example is also simplified because it has not incorporated annual splits to show the return over 12-month periods. But even if this is done, it will still not give a true measure of the investment manager's performance in that the result will be skewed towards the period when the fund was biggest – that is why it is called money-weighted!

3.3.2 Time Weighted Rate of Return

Unlike money-weighted returns, time-weighted returns compound the results for each sub-period. This is regarded as a better measure of performance and is better suited to be an evaluation tool of investment managers' performance: it allows comparisons to be made more easily. The time-weighted return links together elements over the whole period of investment and is not sensitive to contributions or withdrawals. Essentially it is the compounded growth rate over time, hence "time weighed", of the actual investments for all of the sub-periods being measured.

To illustrate the time weighted return let us return to the Example in the money-weighted section. But since we want to show the effect of time and how this affects different managers, we will first of all simplify the data. For these new Examples – and (we are now going to compare managers as well – we will have the following variables:

S is the investment at start of time period

E is the value at end of time period

and we will assume a mid-point value for one of the new Examples

Let R_t be the return.

The formula for each sub period can be expressed as

$$R_t = \frac{E-S}{S} \quad (\text{which at this point is in essence the same as the money-weighted return})$$

For time-weighted performance measurement, the total period to be measured is broken down into many sub- periods, with a sub-period ending, and the portfolio priced, on any day which has significant contribution or withdrawal activity, including fees (or at the end of the month or quarter). Sub-periods can cover any length of time chosen by the manager and need not be of the same length. A holding-period return is then computed by using the following formula which allows for all sub-periods (which have been called 1, 2 etc.)

linked for compounding. This is done by adding 1 to each sub-period, then multiplying all these terms together and finally subtracting 1 from the product, thus:

$$R_t = S \left(1 + \frac{E_1 - S_1}{S_1} \right) \times \left(1 + \frac{E_2 - S_2}{S_2} \right) \times \left(1 + \frac{E_n - S_n}{S_n} \right) - 1$$

where the last function containing “n” represents as many periods as you need in your equation.

An annualised rate of return can be calculated if required but this is not covered in the above formula which concentrates on the nature of the time-weighted performance measurement process.

Worked Examples:

Assume: £50,000 is the total investment

However let us use two investment managers:

Manager A receives £50,000 at the beginning of the period

£55,000 is the value at the end of the period with Manager A

Manager B receives £25,000 at the beginning and £25,000 after six months

The growth rates for each sub-period are shown below.

For Manager A we have only one period - an artificially simple Example - but to evaluate:

$$R_t = \left(\left(1 + \frac{E_1 - S_1}{S_1} \right) \right) - 1$$

$$R_t = \left(\left(1 + \frac{55000 - 50000}{50000} \right) \right) - 1$$

$$R_t = (1.1) - 1$$

$$R_t = 0.1 \text{ which is } 10\%$$

Note that this is almost identical to the money-weighted return Example. Indeed if we ignored (or equalised) the withdrawals and new money in the money-weighted Example, the figures would be identical because there is only one time period. Of course this scenario would rarely be met with in practice so what happens when we have more than one period? This we will apply for Manager B.

For Manager B, therefore, we have two periods, again a very simple Example. But we need a value for the start of the second period. Let's assume that the first period sees an increase of 2%. If Manager A is investing in the same circumstances - and he will be for the purposes of these Examples - then a 10% return on the whole period would mean that the second sub-period would see an increase of 7.84313%. Because Manager B only has £25,000 initially with a further £25,000 part way through the period, the end value for him would not be £55,000: it would be £54,460.78. This Example has (working back from the given returns for each sub-period) pre-calculated the figures at the end of sub periods:

$$R_t = \left(\left(1 + \frac{25500 - 25000}{25000} \right) \times \left(1 + \frac{54460.78 - 50500}{50500} \right) \right) - 1$$

$$R_t = \left((1.02) \times (1.0784313) \right) - 1$$

$$R_t = (1.1) - 1$$

$$R_t = 0.1 \text{ which is } 10\%$$

Note that for Manager B, the end sum is different, being lower in this Example. If the student works out the money-weighted result for Manager B, that will show a lower return. But we know from the figures assumed in this Example that his performance has been exactly the same. This performance is accurately reflected in the time-weighted Example and has allowed for the timing of additional payments.

In practice Manager B would not be likely to deliver the same result as Manager A and, in practice, actual figures would be available. To reflect this, try substituting your own figures for the £25,500 and £54,460.78 used in the formula, remembering to add in the £25,000 extra contribution paid at the start of the second sub-period, and work out a time-weighted return for Manager C.

Performance measurement produces a percentage return for a given period. Two managers, as with A and B above, may produce the same percentage return for that period. But the student should bear in mind that this identical return could have been achieved in different ways. One of the managers may have taken greater risks than another to produce that same return in other words, exposed the client's assets to greater volatility. Performance measurement on software analysis systems nowadays will include measurements of volatility, such as the Sharpe ratio. The mechanisms of this are outside the scope of this manual but the student should be aware of the volatility measurement ratios and understand what a chosen ratio means when making recommendations to his client.

3.3.3 Benchmarks

A benchmark is a standard against which an asset's or a fund's performance can be measured. A client's investment needs may or may not dovetail with a carefully selected benchmarked fund. An adviser should find out the asset allocation for the benchmarked fund and separately would need to establish if this met the client's needs – indeed a benchmark could be customised for an important client or group of clients. For example, the benchmark might be:

- 50% in UK equities
- 20% in overseas equities
- 20% in fixed interest
- 10% in cash.

The return on each asset class within the portfolio should then be calculated to find what it would have been achieved if it had been invested in the appropriate index for its sector (for UK equities this might be the FTSE100 for example). The various indices may have performed as follows:

- UK equities: 20%
- overseas equities: 15%
- fixed interest: 10%
- cash: 5%.

So, looking at just one element of the benchmark components, the return on UK equities in the benchmark portfolio would be: $50\% \times 20\% = 10\%$. The actual index return for all components is applied to the asset allocation of the benchmark portfolio to provide the model rate of return as follows:

| Asset class | Benchmark Asset Allocation | Index Performance for each Asset Class | Contribution to Return |
|-----------------------|----------------------------|--|------------------------|
| UK equities | 50% | 20% | 10% |
| Overseas equities | 20% | 15% | 3% |
| Fixed interest | 20% | 10% | 2% |
| Cash | 10% | 5% | 0.5% |
| Overall return | | | 15.5% |

This benchmark or model performance is then compared with that of the actual portfolio's performance. The table below shows how the manager's asset allocation choice has fared.

| Asset class | Manager's Asset Allocation | Index Performance for each Asset Class | Contribution to Return |
|-----------------------|----------------------------|--|------------------------|
| UK equities | 40% | 20% | 8% |
| Overseas equities | 30% | 15% | 4.5% |
| Fixed interest | 25% | 10% | 2.5% |
| Cash | 5% | 5% | 0.25% |
| Overall return | | | 15.25% |

This example shows that, overall, the manager's asset allocation has not added value over and above the benchmark.

As well as evaluating the manager's overall performance, we may wish to ascertain the effect of the manager's stock selection, within each Asset Class, on the return. Assuming this time that he stayed with the Benchmark Asset Allocation, the Index Performance for each class can be compared with the manager's actual performance. Inputting his Actual Performance for the purposes of this new example, the manager outperformed the UK equity index over the period by 5% and this constitutes 50% of the benchmark, therefore, $(25 - 20) \times 50\% = 2.5\%$. Each of the other components' performance is calculated by the same method.

| Asset class | Benchmark Asset Allocation | Index Performance | Actual Performance | Contribution to Return |
|-----------------------|----------------------------|-------------------|--------------------|------------------------|
| UK equities | 50% | 20% | 25% | +2.5% |
| Overseas equities | 20% | 15% | 5% | -2% |
| Fixed interest | 20% | 10% | 10% | 0 |
| Cash | 10% | 2% | 4% | +0.2% |
| Overall return | | | | +0.7% |

On the basis of figures assumed for the purposes of this example, while the manager performed better in UK equities and cash, much of this gain was offset by the underperformance in overseas equities. Since an adviser can select different managers, the adviser can use this tool to make the decision to use the above manager for UK Equities and Cash, but use a different manager for Overseas Equities and possibly Fixed Interest. The decision of course will depend on the results of and analysis of the adviser's wider research.

3.4 PORTFOLIO REVIEW

The FSMA and the FCA require authorised firms to agree investment objectives with their clients. These objectives and principal factors or constraints on how the portfolio is managed will be set out in an investment policy statement within the Client Agreement.

It may be that the investment manager or advisory firm has a general house style regarding the acceptable level of risk which the fund would generally incur, e.g. a policy not to deal in derivatives. These parameters should be defined so that the client knows the risks and constraints which the manager or adviser will or will not take.

The investment policy statement should be reviewed on a regular basis, probably annually. Also, it may need to be changed to reflect changes in regulation, taxation and the financial environment.

There may also be a number of changes in the client's lifestyle circumstances that can lead to major changes in a client's objectives including:

- inheritance
- illness
- marriage
- divorce
- change in employment, redundancy or retirement.

When the investment objectives are amended or the lifestyle circumstances change, a further Suitability Letter will need to be issued.

Generally, as clients approach retirement they will usually need to take less risk and focus on income rather than capital gain. Typically this will involve moving a portfolio away from equity investments and increasing the weighting in fixed income investments. However, even when approaching "retirement" (which may be partial), investments will depend on the client's objectives and Attitude to Risk (which may or may not require amendment). A person planning to move into drawdown and withdraw only small elements of the fund each year will still be a long-term investor except for that element of his fund which will be taken as withdrawals in the next 18 months or so. A client wanting to use "pensions freedom" to buy the fabled Lamborghini or maybe a holiday home or help a first-time buyer grandchild or pay off the mortgage, may well wish to limit or even eliminate risk so he can be reasonably confident of the amount of cash available.

Also, although you would not expect investor objectives and long term strategies to change in response to short term market changes, there will be a need to reassess strategies in the light of longer term changes in the market. The risks associated with individual asset classes and the relationship between different asset classes will alter over time and new assets will become available to investors. A good example of a new class of investment in the last decade is Emerging Markets Equities - and this example can be developed further in that some investment commentators suggest from time to time that perhaps a correction in favour of developed markets is now called for. And at what stage might an Emerging Market, as was Japan in the 1950s, become developed? Will other Emerging Markets appear? Investment specialists were talking over a decade ago about the "Tiger" economies of South East Asia (and the term "Tiger" has since been applied to other emerging nations). There are also lists produced by investment organisations of Frontier Markets, which markets may eventually be promoted to "Emerging" status. For such reasons (and many others), portfolio review is essential.

As taxation and regulations change new products and services become available: NISAs from 1 July 2014 to give a recent example - though now these contracts are once again called ISAs which in 2015 were accorded greater flexibility. And “pensions freedom” from 6 April 2015 cannot have escaped anyone’s notice. Many of these changes will be complex and require analysis. This could put a strain on investment advisers who may not have the time or the necessary skills to analyse products. In these circumstances, rather than ignoring new products which may be beneficial to clients, advisers should look at using third party advice or external services to assist in deciding whether they are appropriate investments.

3.4.1 Client Reporting

Providing clients with regular reports on their investments allows them to engage in the review process. The frequency of these reports will usually be contained in the terms of the Client Agreement letter given to the client, pursuant to COBS 8.1.2 in the FCA Handbook, or it should be agreed in writing (on “paper or other durable medium” is specifically prescribed) between the investment manager/adviser and the client. And remember too that COBS 8.1.4 states that a firm must establish a record that includes the document or documents agreed between it and a client which set out the rights and obligations of the parties, and the other terms on which it will provide services to the client.

Typical items included in a report include:

- purchases and sales
- summary portfolio valuation and cash statements showing income, interest received, dividends collected and cash outflows
- general market commentary and calculated investment return earned by the portfolio compared with the appropriate and agreed market indices and other benchmarks
- recommended changes in investment strategies.

These reports will normally be at quarterly or half-yearly intervals, except for sales and purchases which are reported on an ongoing basis.

Contract notes should be prepared and dispatched immediately after each purchase and sale. It will normally include the following information:

- bargain date
- person for whom the purchase was made
- number of shares bought/sold and the price
- full name of the share
- amount of commission and other charges, including stamp duty
- settlement date.

Summary portfolio valuations are normally issued quarterly or half-yearly (the frequency should be set out in the Client Agreement) and typically show:

- portfolio value at the date of the last report
- addition of cash or stock
- reduction by each withdrawal
- appreciation or depreciation
- new portfolio value and the date of the report.

Details of holdings – individual holdings will be itemised and will provide the client with details of:

- the holding and description
- market price and value
- book or acquisition cost
- gross income and dividend yield.

Other reports vary depending on the nature of the investment service and the reporting basis agreed between the adviser and the individual client. On-line dealing and reporting agreements will further modify the precise nature of the service.

3.4.2 Rebalancing

A rebalancing of the portfolio will often result from the portfolio review process. Or it may be done automatically at pre-determined periods if allowed for in the Client Agreement.

If arising from the review process, transactions may result from a change in the asset allocation or a change in the securities being held in an asset class. A switch in investments arises when a new investment is effected following the full or partial encashment of an existing investment. Where an investment is genuinely underperforming it should be replaced if it can be demonstrated that a switch is in the best interests of the client, after taking account of transaction costs and any tax implications.

Where a switch is being made primarily to generate fees for the benefit of the firm, rather than in the client's best interests (often referred to as churning), this clearly breaks the code of business rules imposed by the FCA. The adviser should therefore ensure that a client-centric reason for rebalancing is established

A justifiable switch generally arises in one or more of the following circumstances:

- there is a change in the client's objectives or circumstances that requires a move to investments with less or more risk exposure or a change in yield
- market conditions adversely affect the original investment or weigh in favour of an alternative investment
- the client gives clear instructions to effect a switch
- there has been consistent underperformance of an investment over the medium to long term
- the value of an investment is returned as part of a takeover or capital restructuring.

There may be tax implications when disposing of an investment, e.g. gains made from property, collective investments or shares could be liable to a Capital Gains Tax charge. There may be ways to reduce or eliminate this charge either by offsetting any gain against other realised losses or by transferring that asset to the investor's spouse before it is sold where he or she has not used their annual CGT exemption.

Given that the CGT allowance is lost if not used, there could be merit in crystallising gains on investments which have performed well. On the other hand, if CGT is payable, it might be worth deferring the switch until a later tax year but remember not to allow tax considerations to override more important investment considerations. The decision will depend inter alia on the quality of the investments being replaced/purchased and the charges and taxes that need to be paid in relation to the transaction. If (particularly when a new client is being advised) the investment is a single shareholding in a company and constitutes a high proportion of the client's wealth, the high level of risk associated with this lack of diversity could make the switch essential, despite the tax charge. However, the decision would not be so clear cut if the investment is in a collective investment, such as a unit trust, which has not performed adequately. Tax considerations should not usually be the prime reason for switching or not. The prime consideration will be the investment itself and how that tessellates with the investor's objectives.

3.5 WRAPS AND OTHER PLATFORMS

We considered in detail the nature of wraps in the Taxation, Retail Investment and Pensions unit. Briefly, trading platforms are internet-based services used by intermediaries (and increasingly by clients) to view and administer investments. They tend to offer a range of tools which allow advisers to see and analyse a client's overall portfolio, and accordingly choose products for them. As well as arranging transactions, platforms generally arrange custody for clients' assets.

The term "platform" can be used to cover both wraps and fund supermarkets. Wraps and fund supermarkets are similar, but while fund supermarkets tend to offer wide ranges of unit trusts and OEICs, wraps often offer greater access to other products as well. Wraps also tend to support advisers who want to agree their own remuneration with their clients, instead of receiving commission.

Using platforms could improve an adviser's administration and, thereby, the services offered to clients. However, advisers need to make sure that this does not simply increase complexity and costs which are passed on to clients, without giving them new services they value in return.

3.5.1 Changes to an Adviser's Business

Advisers may need to make changes to their business operations to adopt and use platforms successfully. For example, they will need to identify the business areas affected, assess the potential impact upon them and manage the change. This can include:

Segmenting customers: if the platforms the adviser is considering are not appropriate for all his customers, he may need to divide them into separate groups that are monitored differently. Segmentation of clients increasingly occurred in the run-up to and subsequent to the introduction of RDR. Escalated regulation means that the pressures on advisers' time has increased and the FCA's requirements to treat clients fairly avoiding inter-client cross subsidy mean that the client with £20,000 in one ISA is not going to be seen as frequently as the High Net Worth (HNW) client with £1,000,000 in widely differing investments. Formal segmentation is a way of establishing the above ISA client as a "standard" client, seen once a year in the office (or only dealt with over the phone), while the HNW client is a "premier" client seen at his home on a quarterly basis. Again the Client Agreement is key: the level of service and charges for that service need to be agreed in writing.

Developing new service propositions: adopting a platform may mean providing a new type of service, such as regular investment reviews, which may need to be managed differently. All advisers need to consider the use of more than one platform to satisfy FCA requirements to review the whole market (see section Platforms and Independence below).

Assessing and adopting new systems and processes: this will have implications for training and managing staff, both during the transition and afterwards.

Managing changes of income and expenditure: this is particularly likely to be relevant if the firm adopts a new form of adviser remuneration through a platform, and may mean considering how to maintain the financial position of the firm.

3.5.2 Risks in the Firm

Adopting and using platforms may present risks for a firm and its customers that are different to those previously identified. For example, the firm may be moving from offering one-off, transaction-based advice to providing an ongoing advice service. Consequently, the current risk management procedures may need to be reviewed.

3.5.3 Conflicts of Interest

Platforms can create conflicts of interest – between the platform provider and the firm, the firm and its advisers, the advisers and their clients and even different groups of clients if cross-subsidy is involved – which will need to be managed appropriately. Remember too that Principle for Business 8 requires that a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client. For example, a firm's desire to make an administrative cost saving should not lead to customers being recommended to use a platform when this is not in their interests. And as mentioned above, the FCA would not expect an IFA to use one platform only ignoring the offerings available throughout the whole market.

3.5.4 Competence

Using platforms will have training and competence implications for a firm, advisers and other staff. In particular, a firm, again meeting FCA Competence standards, will need to make sure that relevant staff understand:

- how to use the platform and associated tools
- the firm's new service proposition and what it involves for different staff
- any changes to firm procedures
- particular types of investments – especially those which were not normally considered before adopting the platform
- asset allocation and portfolio construction
- how to assess and explain the costs involved in using a platform.

3.5.5 Asset Allocation Issues

Platforms (and associated tools) may make it easier for an adviser to construct and re-balance investment portfolios where the firm takes control of the asset allocation decisions. This is different to a managed fund or multi-manager fund where these asset allocation decisions are made by the product provider.

When considering the firm's approach to asset allocation it will need to take account of the resources required and the training needed to ensure all staff involved are competent in this area.

Some platforms offer the facility to identify all clients with a particular holding and subsequently, the ability to “bulk switch” these clients from one holding to another. These facilities may be of some use to firms who provide ongoing advice to clients on their portfolios, unless the approach to asset allocation varies between clients.

Where the firm is not providing an ongoing review service, it should consider if an investment solution that is self-rebalancing is more suitable for the client. At the very least, it should make sure the client is aware of the implications of not re-balancing their portfolio regularly.

3.5.6 Suitability

Suitability (and COBS 9.3 refers) is not just something to consider regarding the particular investment an adviser is looking at when advising a client. A firm must also consider the suitability of the platform service itself. When researching which platform to adopt, a firm might want to consider:

- its overall business model and the type of services it wants to offer – which might differ depending on the type of client
- its typical target market and approach to client segmentation
- its remuneration model – e.g. fees, commission or a combination
- existing systems and procedures
- the reputation and financial standing of the platform provider
- terms and conditions of using the platform
- charges – including actual cost, charging structure and transparency of charges
- range of funds, tax wrappers and other products available

- range of asset classes
- functionality (for example the ability to switch or re-register off platform or record legacy assets)
- accessibility
- additional tools (for example, risk profiling and asset allocation tools)
- support services (for example, help facilities and training).

However, the suitability of any platform will depend upon the client's particular circumstances and requirements. Irrespective of any strategic decisions (relevant to the firm) to use a platform, a firm must still consider whether a platform is suitable and meets each client's needs before recommending it. This includes any recommendation that existing clients move onto a platform.

3.5.7 Platforms and Independence

Where the firm wants to call itself "independent" it must meet the following requirements whether or not it uses platforms:

- advice must be provided on packaged products from the whole market (or the whole of a named sector of the market)
- customers must be given the opportunity of paying for advice through fees.

When considering whether to recommend a product through a platform, an adviser may need to consider the advantages and disadvantages that may arise from using the platform, and the platform's terms and conditions, rather than considering the product in isolation. Overall though, an adviser cannot assume that a particular product or tax wrapper (e.g. an ISA, life assurance bond or self-invested personal pension) available through a platform will be the best choice in all cases.

There is no limit on the amount of business an adviser can place with one platform provider. However, he must make sure he rigorously assesses which product is most suitable for each client and record the reasons for his decisions. The FCA, with its eye on the Inducements section of COBS, would enquire as to the rationale for an IFA placing all business with one platform: an IFA is expected to consider the whole of the market.

For an adviser to be sure that he is giving whole of market advice, he might include one or more of the following:

- considering products from outside the platform – if the platform only offers a limited choice of a particular type of product or tax wrapper, the adviser is unlikely to be able to rely on it as a channel for purchasing that type of product
- using a platform with multiple tax wrappers and packaged products – some platforms support a range of tax wrappers and products such as life assurance bonds. Using these types of platforms may help the adviser meet the whole of market requirements, but he will still need to consider whether the products available are right for the customers
- using more than one platform.

3.5.8 Communications with Clients

When using platform services advisers need to communicate information in a way which is clear, fair and not misleading. This applies to both verbal and written communications and includes:

- explaining the adviser's service and how this involves the platform, clearly stating what services are – or are not – being provided
- document why recommendations involving platforms were suitable
- communicate information about costs, including the cost of the adviser's services (initial and ongoing), any separate costs of the platform service itself and the cost of the underlying investments recommended. The client should be in a position to clearly assess whether or not they are prepared to pay any additional amounts for the platform services provided
- explain the features, advantages and disadvantages of the platform service, including any restrictions or limitations of the service.

Summary

This Chapter considered how investment planning and performance monitoring dovetail with a client's investment requirements. It looked at how portfolios are constructed, both in conceptual terms and how these approaches might meet a client's objectives. Performance evaluation and performance measurement were considered and we have looked at wraps and other investment platforms.

Self Test Questions

- Distinguish between alpha and beta styles of investment management
- What elements should be included in a portfolio review?
- What client-centric events might trigger a portfolio review?
- What key points should be considered when adopting and using investment platforms?
- Is a time-weighted investment return or a money-weighted return better for comparing fund managers' performance?

PART 4

LEGAL CONCEPTS RELEVANT TO FINANCIAL ADVICE

OVERVIEW

There are a number of legal concepts that are relevant to financial advice. Financial advisers need to be aware of these concepts and how they might affect their clients before they make recommendations.

Legal concepts which are described and explained in this Part include:

- legal persons, e.g. sole traders, limited companies and partnerships
- Power of Attorney
- contract law
- agency
- property ownership
- insolvency and bankruptcy
- wills and intestacy
- the use of trusts.

This Part consists of six Chapters.

CHAPTER 1

Legal Persons, Powers of Attorney and the Law of Agency

INTRODUCTION

There are several types of legal person and some of the most common are outlined in this Chapter.

Unlike natural persons who come into existence and acquire Human Rights when born, it requires a legal process to create other legal persons.

Other legal persons include charities, sovereign and local Governments, National Health trusts and cooperative societies: Chapter 6 below also considers trusts. Non-natural legal persons come into existence as a legal entity when they are founded, such as by incorporation for limited companies or by Deed for many trusts. Once in existence, while they do not possess Human Rights, they have legal status, can make contracts, own property, be sued etc. and ultimately can be wound up.

1.1 SOLE TRADERS

The term sole trader is used to describe a business which involves one person who is “self-employed” and who typically owns and runs the operations. The sole trader has no contract of employment with an employer, rather he may provide services for others under contracts for service. Indeed, the sole trader is a natural person and legally whatever he does as a trade is indistinguishable from what he does in personal life.

There are a number of advantages to being a sole trader business. Generally sole trader businesses are easy to set-up and largely depend solely on a decision by the proprietor to enter into business and to start trading. There are no start-up fees and relatively little administration involved in setting up as a sole trader. HM Revenue and Customs (HMRC) must be notified once the decision to start trading has been made but there are no registration fees.

In addition, there is no requirement to prepare statutory accounts or to make public disclosures about income, expenditure or assets held by the business.

There are several disadvantages for sole trader businesses. Chief among these is the fact that the liability of the owner of such a business is unlimited. This means that personal assets can be used to satisfy the debts of the business in the event that the venture is unable to pay. It is principally because of this unlimited liability that a sole trader may, if the business prospers, consider one of the trading styles outlined in the following sections of this Chapter.

As the law does not distinguish between the individual running the business and the sole trader, neither does HMRC. The sole trader and its owner are regarded as one and the same for taxation purposes; therefore the profits of the business are liable to Income Tax in the hands of the owner/sole trader. This Income Tax is payable on the basis HMRC applies to self-employed persons, i.e. it is due twice yearly via self-assessment and it is paid directly to HMRC. Any capital gains by the business will be treated as gains made by the individual and will be subject to Capital Gains Tax.

The proprietor will be liable to pay National Insurance Contributions (NICs) as a self-employed person, i.e. he will pay Class 2 and Class 4 NICs. We considered the details of these contributions in Taxation, Retail Investment and Pensions.

Where a sole trader has employees, the employees have a liability for Income Tax under PAYE; primary Class 1 NICs are also due in respect of those employees. The sole trader is responsible for operating the PAYE procedures for the business's employees and for accounting to HMRC for deductions. The sole trader is also liable to pay secondary Class 1 NICs. (Note: primary Class 1 contributions are the employee's portion, and shown as such on their payslips, while secondary Class 1 contributions are the additional amounts paid by the employer in respect of those employees.)

1.2 PARTNERSHIPS

An unincorporated or traditional partnership has similar features to a sole trader business except that there are two or more owners instead of just one.

As with a sole trader, each partner has unlimited liability for the debts of the partnership. HMRC treats them as self-employed for tax and National Insurance purposes and requires them to pay Income Tax and NICs on their share of the partnership's profits.

The share of the profits which an individual partner receives will be dependent on the percentage or amount agreed by the business. It is usual for a formal partnership agreement to exist which, among other things, will stipulate the share of any gains to which each partner will be entitled.

In practice, the profits split might depend on the length of time the person has been a member of the partnership, how much income the individual partner generates or the level of initial investment contributed by each.

Unlike limited companies, when one partner leaves or joins the business, that entity is deemed to have been dissolved and another created.

Where the partnership has employees, the employees have a liability for Income Tax under PAYE; primary Class 1 NICs are also due in respect of those employees. The partnership is responsible for operating the PAYE procedures for the business's employees and for accounting to HMRC for deductions. The partnership is also liable to pay secondary Class 1 NICs.

1.3 LIMITED LIABILITY PARTNERSHIPS

The Limited Liability Partnership Act 2000 introduced a new type of partnership in 2001. Limited Liability Partnerships (LLPs) bear some characteristics of both a company and an unincorporated business. Normally there must be at least two members and unless there are more than 20 members their names need to be shown on the LLP letterhead. If membership exceeds 20 then a list of members should be made available at the principal place of business.

The similarities with limited companies include their registration and regulation by Companies House and the requirement to have a UK registered office address. Also, LLPs provide owners with restricted exposure to the business debts. Their personal assets are ring-fenced away from the liabilities of the venture. LLPs, therefore, have proved attractive to professional firms that might face the risk of large liability claims, e.g. solicitors.

The death, leaving, retirement or bankruptcy of a member does not end the LLP: their membership ceases on the terms set out in the LLP agreement. A corporate body may also be a member of a LLP.

HMRC, however, treats LLPs as traditional partnerships for tax and National Insurance purposes. The partners continue to be treated as self-employed and pay tax and NICs on their share of the profits. LLPs do not pay corporation tax. Employees of an LLP are treated in the same way as ordinary partnerships for tax and NICs purposes.

Note that there are also Limited Partnerships which existed before 2001 in which a general partner (or partners) assumed unlimited liability, while the limited partner(s) enjoyed limited liability, perhaps because he took no part in the running of the business but had simply invested capital.

1.4 LIMITED COMPANIES

A limited company is a business entity which exists in its own right, i.e. it has a legally separate identity from the owners of the business. A company owner could sue the company bearing his name and vice versa: unlikely but it does happen where the owner and the Board irrevocably disagree. *Salomon v. A Salomon & Co Ltd* [1897] AC 22 is a landmark UK company law case: the effect of the Lords' unanimous ruling in that case was to uphold firmly the doctrine of corporate personality, as set out in the Companies Act 1862, so that creditors of an insolvent company could not sue the company's shareholders to pay up outstanding debts. The owners of the business are made up of its shareholders. Should the owners retire or die, the company continues to exist: Marks & Spencer plc and The Ford Motor Company are well known examples.

All limited companies in the UK must be registered with the Registrar of Companies before they begin trading and must provide specified information and yearly accounts to Companies House, the Government body charged with incorporating and dissolving UK limited entities. Registration details of all limited companies are accessible on <http://www.companieshouse.gov.uk>. The company's accounts are made available to the public through Companies House.

In contrast to its approach with partnerships and sole traders, HMRC makes a distinction between the profit the company earns and the amount if any, which is distributed to the owners. Limited companies do not pay Income Tax or Capital Gains Tax, however, they do pay Corporation Tax on all forms of profit (including capital gains) made by the company. Also, the company is not liable to NICs on business profits. Where the owners are also employees of the company, e.g. directors, any income paid to them as an employee will be treated as employment income and will be liable to primary Class 1 NICs. Where the employee is paying primary Class 1 NICs the company will be liable for secondary Class 1 NICs on these earnings.

Limited companies can be identified by the words "Limited" (Ltd) at the end of the company name if it is a private company or "public limited company" (plc) if it is a public company which has floated on the Stock Exchange. There is no difference between private and public limited companies from a taxation point of view. However, a private company, unlike a plc, is unable to advertise its shares for sale. These shares can only change hands by way of a private agreement.

The majority of limited companies are limited by shares. Occasionally a not-for-profit company may be limited by Guarantee when the members act as guarantors to provide a sum of money (often very small) in the event of wind-up.

1.5 PUBLIC LIMITED COMPANIES

When a company becomes listed on the Stock Exchange, which is when it usually achieves its “public” status, additional requirements are placed on it because of the need to protect investors who can now freely buy its shares on the Stock Exchange. A plc must state that it is a public company and its name must end with either “public limited company” or “plc”. Additional requirements for public limited companies include:

- a plc must have minimum capital of £50,000 of which 25% must be fully paid
- a plc must have least two directors and two shareholders
- at least one director must be an individual and all individual directors must be aged 16 or over
- a plc must have at least one qualified Company Secretary.

A company incorporated as a plc cannot conduct business or exercise borrowing powers unless it has obtained a trading certificate from Companies House, confirming that it has the minimum allotted share capital. It is an offence to trade without a trading certificate and the directors are liable, on conviction, to a fine. (Occasionally a company may have satisfied the requirements to call itself a “plc” to raise its profile with its customers but chooses not have a Stock Exchange listing.)

A public limited company must hold an annual general meeting at which it presents its accounts to shareholders and must file its accounts with Companies House within seven months of the end of its accounting period. It cannot waive the requirement of audited accounts and cannot provide abbreviated accounts.

Other requirements include the disclosure of shareholdings in the company and the release of information that might affect the share price.

Takeovers and mergers of listed companies are controlled by the Takeover Panel, a regulatory body set up in 1968 to ensure the fair treatment of all shareholders in takeover and merger situations.

There are two principal ways in which a company can be quoted on the London Stock Exchange.

- **Main Market:** the Main Market is London’s flagship market for larger, more established companies, and is home to some of the world’s largest and most well-known companies.
- **AIM:** other companies, wishing to grow and perhaps become fully-listed plcs in a decade or so, opt, with the support of and supervision by a Nominated Adviser (probably a merchant bank and known as a Nomad), for an AIM listing at the London Stock Exchange. The investments are unregulated in that they do not have to follow all Stock Exchange rules though they do need to prepare annual accounts unlike private limited companies. AIM was founded as the Alternative Investment Market in 1995. Investors in AIM companies enjoy tax breaks but such investments should be regarded as high risk.

The September 2017 Main Market report of the London Stock Exchange gives the value of 938 companies on the Main Market as £2,512,332.6 million, while the corresponding figures for AIM listed companies are 959 companies worth £98,971.5 million.

1.6 POWERS OF ATTORNEY

The most basic type of Power of Attorney is what is known as a general power, given under section 10 of the Powers of Attorney Act 1971. Under this, a person (the Donor) can create a general power of attorney which allows another individual (the Attorney) to manage their affairs (the Power of Attorney can also be granted to two or more people to act jointly or severally). This is usually made when it is difficult for the Donor to manage their affairs, for example because of a physical disability or when the person is travelling abroad. A general Power of Attorney may be made on a temporary basis.

Under a Power of Attorney:

- the Donor executes a deed giving another person (or persons), known as the Attorney (or donee), the authority to act on their behalf;
- the authority may be limited to a specific matter, such as the completion of a property transfer, or it may be general in nature;
- the deed should be signed by the Donor and witnessed by at least one person. A person of unsound mind cannot complete a Power of Attorney;
- the Donor may revoke the power. Normally, it is automatically revoked on the Donor's death/bankruptcy or if the Donor becomes of unsound mind;
- the Attorney cannot make gifts, either to themselves or others. Their power is limited to administration.

Where there is a Power of Attorney, the adviser and any other financial institution involved will need to have a clear idea of what powers this confers. These will be stated in the Power of Attorney, this power either being specifically written by a solicitor or with the power based on the standard, for the general Power of Attorney, in the 1971 Act. The Power of Attorney should also make clear the period of time for which that power is valid and it should give authority for the intended transaction.

Unless a general power is expressed to be irrevocable, it can be revoked by the Donor, or by the expiry of the period specified in the power, or by the death, bankruptcy or supervening mental incapacity of the Donor or the Attorney. If the Donor revokes the power then they must notify the Attorney.

The removal of this general power with the onset of mental incapacity of the Donor, perhaps when a Power of Attorney was most needed, led to the introduction of the Enduring Powers of Attorney Act 1985 and the Mental Capacity Act 2005.

1.6.1 Enduring Power of Attorney

The Mental Capacity Act 2005 came into force on 1 October 2007. However, older, pre-2007 Powers of Attorney still exist and a summary of the pre-2005 position follows.

The Enduring Powers of Attorney Act 1985 was introduced to allow for an individual holding a Power of Attorney to continue to act for the Donor in the event of his mental incapacity. An enduring power can only authorise Attorneys to make decisions about the Donor's property and financial affairs.

While the Donor has full mental capacity, an enduring power usually confers the same powers as a general Power of Attorney. In this case the enduring power does not have to be registered before it can be used, unless there is an express condition requiring registration. The enduring power must be registered with the Office of the Public Guardian (OPG) as soon as the Donor starts to lose capacity. This registration may be cancelled on the Donor's recovery.

Everyone is assumed to have mental capacity unless it can be proved otherwise. A person lacks capacity if they cannot make decisions for themselves due to impairment in the functioning of the mind which could be temporary or permanent. An individual is unable to make a decision for themselves if they cannot:

- understand the relevant information
- retain that information
- evaluate that information in making the decision, or communicate that information.

An Enduring Power of Attorney must meet the following requirements:

- established before 1 October 2007 (it does not need to have been registered)
- the Donor and Attorney had mental capacity
- the Donor and Attorney were over age 18 and not bankrupt
- satisfies the conditions of the Enduring Powers of Attorney Act 1985
- the Attorney registers the enduring power with the OPG as soon as the Donor starts to lose capacity.

Where individuals wished to retain control over their own affairs while they had mental capacity it was possible to restrict the power so that it only came into force when it was registered with the OPG.

An enduring power can be revoked by the individual at any time, except that if it has been registered it can only be revoked with the consent of the Court of Protection. It is automatically revoked if the Donor or the appointed Attorney becomes bankrupt or dies.

The Enduring Powers of Attorney Act 1985 was repealed by the Mental Capacity Act 2005, but it was reintroduced almost in its entirety in Schedule 4 of the MCA 2005. It is not possible to make new Enduring Powers of Attorney, although the operation of existing enduring powers made before 1 October 2007 will fall under Schedule 4 of the MCA 2005.

1.6.2 Lasting Power of Attorney

The Mental Capacity Act 2005 introduced a new format: the Lasting Power of Attorney. There are two different types of Lasting Power of Attorney:

- Health and Welfare Lasting Power of Attorney (sometimes called a Personal Welfare Lasting Power of Attorney)
- Property and Financial Affairs Lasting Power of Attorney.

A Health and Welfare Lasting Power of Attorney allows the Donor to choose one or more people to make decisions for things such as medical treatment. This can only be used if the Donor lacks the ability to make decisions for themselves.

A Property and Financial Affairs Lasting Power of Attorney lets the Donor choose one or more people to make property and financial affairs decisions on his or her behalf. This type of lasting power can be made at any time and may include a condition that means the Attorney can only make decisions when the Donor loses the ability to do so themselves.

The Donor must be over 18 with mental capacity and the Attorney must be over 18 with mental capacity and not be bankrupt. If the Donor is or becomes bankrupt, the bankruptcy order would restrict the Donor's/Attorney's powers re dealings on property.

There are separate forms for making a Property and Financial Affairs Lasting Power and a Personal Welfare Lasting Power. Copies of the blank forms and explanatory leaflets can be obtained from the OPG; standard wordings are also available from the Ministry of Justice. Before the lasting power is valid, the Donor must have a certificate of capacity drawn up by an independent third party called a Certificate Provider. The Certificate Provider could be a solicitor, doctor or another independent person that the Donor has known personally for at least two years. The prescribed form must be completed and signed in the presence of a witness and each Attorney must sign to confirm they have read the explanatory information and understand the duties imposed upon them.

In addition, the Donor should list one or more named persons to be notified of any application to register the lasting power. If none are listed then an additional certificate of capacity must be provided.

Lasting Powers of Attorney must be registered with the OPG before they can be used regardless of whether the Donor still has mental capacity. Once registered, the Attorney can act for the Donor immediately under a Property and Financial Affairs Lasting Power. However, Attorneys can only act under a Health and Welfare Lasting Power if the Donor has lost the capacity to make such decisions for themselves. If the Attorney believes that the Donor does not have the capacity to make a certain decision he must have regard to the MCA 2005 and the Code of Practice, issued by the Lord Chancellor on 23 April 2007 in accordance with sections 42 and 43 of the Act, when making that decision for the Donor.

The Donor can cancel the lasting power at any time if he has mental capacity. A Lasting Power of Attorney automatically ends if:

- the Donor or the Attorney dies
- the Donor or the Attorney becomes bankrupt)
- a marriage or civil partnership between the Donor and the Attorney is dissolved or annulled
- the Attorney lacks the mental capacity to make decisions
- the power is “disclaimed” (or rejected) by the Attorney.

1.6.3 Court of Protection

Where people are incapable of managing their own affairs because of mental incapacity, they fall under the jurisdiction of the Court of Protection (COP) which was established under the MCA with its initial Rules set out under SI 2007/1744 effective in October 2007. The COP makes decisions and appoints Deputies to act on behalf of people who are unable to make decisions about their personal health, finance or welfare.

The MCA is underpinned by five statutory principles that provide a benchmark for decision-makers and carers:

1. Every adult has the right to make their own decisions and must be assumed to have capacity unless it is proven otherwise.
2. People must be given all appropriate help before they can be considered unable to make their own decisions.
3. Individuals have the right to make unwise decisions, including decisions that others may consider eccentric.
4. Anything done for or on behalf of a person who lacks capacity must be in their ‘best interests’.
5. Anything done for or on behalf of a person who lacks capacity should be the least restrictive of their basic rights and freedoms.

As a superior court equivalent in power to the High Court, the COP has the power to:

- decide whether a person has capacity to make a particular decision for themselves
- make declarations, decisions or orders on financial or welfare matters affecting people who lack capacity to make such decisions
- appoint Deputies to make decisions for people who lack the capacity to make those decisions
- decide whether an LPA or EPA is valid
- remove Deputies or Attorneys who fail to carry out their duties
- hear cases concerning objections to the registration of an LPA or EPA and make decisions about whether or not an LPA or EPA is valid.

In reaching any decision, the COP must apply the statutory principles set out in the MCA. It must also make sure its decision is in the best interests of the person who lacks capacity.

1.6.4 Court-appointed Deputies

A Deputy, who must be aged 18 or over, is usually a close friend or family member of the person who needs help in making decisions. A Deputy can also be a professional. The COP decides who can be a Deputy.

The Deputy must apply to or be appointed by the COP to become someone’s Deputy. They can be appointed as a Deputy for property and financial affairs or a Deputy for personal welfare. The power can relate to specific aspects. Guidance OPG510 has been issued for the assistance of Court-appointed Deputies and (taking an extract from OPG510) inter alia Deputies should always:

- make decisions in the person’s best interests
- make only those decisions authorised by the Court Order
- have regard to all relevant guidance in the Code
- adhere to the Act’s five statutory principles
- apply a high standard of care when making decisions.

The Deputy must liaise with the COP with regard to the investment of any capital.

When a mentally incapacitated person dies, the powers of the Deputy are terminated automatically and the person's legal personal representatives then deal with their property. This restriction is easily understood if you think about the role of a professional Deputy who may be a solicitor or medical specialist who deals with a person's affairs during their lifetime but on death the Executor would take over to use his family knowledge to ensure that appropriate funeral arrangements are made.

A Deputy is not the same as an Attorney and only has the powers specifically given in the COP Order. The specific powers granted will depend on the needs of the person who lacks capacity and the Court's decision.

The Office of Public Guardian can investigate a Deputy if they believe he is not fulfilling his duties properly. The Deputy should therefore keep a record of any decision made in the role, for example notes about any meetings with a doctor and correspondence from health agencies or social services.

The COP may be asked to make a single order. This will usually be the case where there is otherwise no ongoing need to have financial powers.

There are restrictions on trust planning and investments. A Deputy is not able to make certain decisions which include.

- making a Will or any addition to a Will on behalf of the person;
- making large gifts out of the person's money;
- holding any money or property on behalf of the person.

1.6.5 The Office of the Public Guardian

The Office of the Public Guardian (OPG) protects people who lack the mental capacity to make their own decisions. The OPG supports and promotes decision making for those who lack capacity or who would like to plan for their future, within the framework of the MCA.

The OPG is responsible for:

- supervising Court-appointed Deputies
- keeping registers of Deputies, Lasting Powers of Attorney (LPA) and Enduring Powers of Attorney (EPA)
- investigating complaints about Deputies and Attorneys acting under a registered EPA or LPA.

In some cases, where there are suspicions that an Attorney or Deputy might not be acting in the best interests of the person they represent, the OPG will work with other organisations to ensure that any allegations of abuse are fully investigated and acted on.

The Public Guardian per se is an individual whose role it is to protect people who lack mental capacity from abuse. The Public Guardian is also personally responsible for the management and organisation of the OPG, including the use of public money and the way it manages its assets.

A separate Public Guardian Board scrutinises the work of the Public Guardian and then reports to the Lord Chancellor.

1.6.6 Independent Mental Capacity Advocate

The Independent Mental Capacity Advocate (IMCA) service was created as a statutory advocacy service by the Mental Capacity Act. The IMCA is appointed by the local authority/health authority to make decisions on behalf of the person who lacks capacity to support that individual who lacks capacity but has no one to speak for him or her. (Normally, family members would speak on the individual's behalf.)

An IMCA safeguards the rights of people who:

- are facing a decision about a long-term move or about serious medical treatment;
- lack capacity to make a specified decision at the time it needs to be made;
- have nobody else who is willing and able to represent them or be consulted in the process of working out their best interests, other than paid staff.

An IMCA can be appointed for people with learning disabilities, older people with dementia, people who have a brain injury or people with mental health problems where the individual is faced with certain decisions about serious medical treatment and long-term care moves. But IMCAs also act when people have a temporary lack of capacity because they are unconscious or barely conscious whether due to an accident, being under anaesthetic or as a result of other conditions. IMCAs only become involved when certain decisions need to be made involving serious medical treatment.

For example, a person with a severe brain injury who has no friends or family and who cannot communicate through language will have an IMCA to make representations about their wishes, feelings, beliefs and values. The IMCA will bring to the attention of the decision-makers all factors that are relevant to their decision.

Decision-makers in the National Health Service (NHS) and in local authorities (for example doctors and social workers), will have a duty to consult the IMCA for the most vulnerable, i.e. those who have no family or friends to be consulted.

IMCAs are also involved in a change in the person's accommodation where it is provided by the NHS or a local authority.

The IMCA can challenge decisions made by an Attorney or Deputy.

1.6.7 Express Permissions

One specific aspect of Powers of Attorney which the financial adviser may need to check out concerns the Express Permissions granted to the Attorney to authorise new and continued investments. The OPG's guide LP12, Make and register your Lasting Power of Attorney, September 2015, contains a section which refers to alternative ways in which a Donor can give permissions and instructions for investment. It is prudent for the adviser to check that action he takes on behalf of the client is consistent with the terms originally set out by the client, including whether permission has been granted for discretionary investment management.

1.7 LAW OF AGENCY

The law of agency is an area of commercial law dealing with a contractual or quasi-contractual (or non-contractual where trusts are involved) set of relationships when a person, called the agent, is authorised to act on behalf of another (called the principal) to create a legal relationship with a third party.

This is common in insurance and investment businesses. It applies to the relationship between someone seeking insurance and any independent financial adviser (IFA) they use to find the most suitable product on the market for them. In this relationship the principal authorises the agent to negotiate on his or her behalf or bring him or her and third parties into contractual relationship.

As the IFA is the agent of the client he owes a duty of care to the client, not to the insurer. However the IFA must comply with the relevant FCA rules. Also, as the IFA is the agent of the client, the client is responsible for the acts of the IFA. This would mean that if a material fact was disclosed by the client to the IFA but it was not disclosed to the insurer there would be non-disclosure and the insurance contract would be void (see section 2.1, Contracts, below). Insurance companies are not responsible for the actions, or failures to act, of IFAs.

However, if the agent is a representative of the insurance company, either employed or self-employed, and the agent fails to pass on a material fact supplied by the client to the insurance company's underwriters, there has been no non-disclosure and the insurance contract would be valid. Appointed Representatives are agents for their principal firm.

Interestingly, barely half a century ago many intermediaries, perhaps trading as brokers, were essentially agents of one or more insurance companies. The capacity in which they acted was not as clear-cut as it must be today. The Client Agreement makes clear the status of the adviser.

Summary

This Chapter has considered the legal status of individuals, partnerships and companies. The safeguarding of the rights of individuals unable to act for themselves and the use of Attorneys as well as the role of agents have also been discussed.

Self Test Questions

- What are the advantages and disadvantages of being a sole trader?
- What is a limited company?
- What additional requirements, with regard to company officials, need to be met when a limited company is a plc?
- Why might an LLP be established?
- What are the five statutory principles of the MCA?
- Describe a Lasting Power of Attorney and its uses
- When is an adviser the agent of the client and when is he the agent of the provider?

CHAPTER 2

Law of Contract and Capacity

INTRODUCTION

This Chapter considers the pre-requisites for a person to be capable of entering into a contract, the requirements for contracts to be valid and specific features affecting insurance contracts.

2.1 CONTRACTS

All packaged investments are contracts and act in the same way as contracts for every other trade or business. For a binding contract to exist certain conditions must be fulfilled:

- there must be an offer (such as an insurance company offering to provide life assurance) and an acceptance (i.e. the applicant accepting the terms offered)
- there must be an intention to create a legally binding contract and both parties must be legally capable of entering into a contract
- there must be consideration, i.e. both parties must pay or stand to contribute something of value to the other – the client a fee and the adviser his expertise.

In the case of life assurance contracts, however, the additional requirements of utmost good faith (now modified) and insurable interest must also apply.

Utmost good faith means that the proposer of a policy must declare on the proposal form all the facts which a reasonable person would think that a life office's underwriter might want to know in relation to their health or other circumstances relevant to the mortality risk or indeed any other insured risk. Uberrima fides, as it used to be known, is a long-standing insurance precept. But because of the perceived difficulty a lay person can have in deciding what is reasonable, this responsibility was changed as part of TCF considerations. The Consumer Insurance (Disclosure and Representation) Act 2012 came into force on 6 April 2013. It removed the duty on consumers to disclose any facts that a prudent underwriter would consider material and replaces this with a duty to take reasonable care not to make a misrepresentation. One of the factors to be taken into account when determining whether or not a consumer has "taken reasonable care", is whether or not the questions asked of them at policy inception were clear and specific. The Act removed the strict duty of utmost good faith and duty of disclosure when transacting consumer contracts and imposed the new duty to take reasonable care. The key points are:

- the new regime essentially grants statutory 'permission' for consumers to make honest but reasonable misrepresentations and still expect claims to be paid
- it is intended that insurers should and will pay more consumer claims.

The principle of taking reasonable care is being updated. The 2015 Insurance Act, effective from 12 August 2016, modified the duty of disclosure by the client to require the client to make "fair presentation". It is then up to the insurer to make further enquiries of the client should it deem necessary

Insurable interest requires the proposer, i.e. the party to whom the benefits will be paid, to have some financial interest in the life assured. Examples may help to make this clear: an individual has an insurable interest in his own life and in his spouse's; a creditor will have an insurable interest in his debtor's life (to the extent of the debt); a company will have an insurable interest in the life of a key director or employee. The concept of insurable interest was first introduced in the Life Assurance Act 1774, also known as the Gambling Act, Section I of which sought to deal with contemporaneous abuses. The 1774 Act stipulated that no assurance was to be made on the life of any person or persons, or on any other event, where the person for whose use the policy was made had "no interest" in the matter. If it were clearly done for the intent of "gaming or wagering", any assurance was deemed null and void. Just over thirty years prior to 1774 people had been "placing bets" on whether King George II, the last British monarch to lead his troops into battle, would survive the Battle of Dettingen or be taken prisoner, with the "bets" being accepted by Lloyds' syndicates. Such "life assurance" was not uncommon in the mid-18th century! (Some readers might think that things have not changed too much with the emergence of high risk derivative investment contracts - though that type of investment is not contingent on the continuation of a human life and the insurable interest principle is not relevant! Remember though to check carefully a person's Attitude to Investment Risk if you do get involved with such high risk investments!).

Insurable interest remains relevant in the context of possible over-insurance. Insurers will effect financial and as well as medical underwriting where Sums Assured are very high e.g. £2,000,000 for a 20-year old even where that 20-year old may be a member of a very wealthy family. In practice, it is up to the insurer and proposer to agree an amount which represents the insured loss in the event of the assured's death. The point is: does the insurable interest extend up to the amount of Sum Assured requested? On this point, the adviser will have a role in either convincing the insurer to provide very high cover or explain to the proposer why he cannot have the amount requested.

2.2 CONTRACTUAL CAPACITY

Some people are subject to special rules which restrict their contractual capacity. The main categories affected are minors, people who are mentally ill and people who are intoxicated.

2.2.1 Minors

Under English law, the age of contractual capacity for individuals is 18 (reduced from age 21 by the Family Law Reform Act 1969). Minors are those who have not attained the age of 18. Minors are permitted to enter into contracts for limited purposes, and the test is one that focuses on the nature of the transaction, and whether the minor is of an age such that they are capable of understanding it. The main reason for these rules is to protect minors from their inexperience which might see them enter agreements which disadvantage them.

Generally, contracts entered into by children that are for "necessaries" are binding on children, as are those for apprenticeship, employment, education and service where they are for the benefit of the child. "Necessaries" includes the supply of food, medicines, accommodation, clothing, amongst other things but generally excludes conveniences and products and services for comfort or pleasure. Commercial or "trading" contracts are excluded. These latter contracts are voidable at the option of the minor, and whether the minor may avoid the contract depends on the nature of the contract.

Contracts where the minor may avoid the effect of the contract are for the acquisition of a legal or equitable interest in property of a permanent nature, such as shares, land and partnerships. Other contracts require positive ratification in order to be enforceable, which includes contracts for debts and the sale of goods that are not for necessities. The ratification must take the form of an acknowledgement that the debt is binding after attaining the age of 18.

2.2.2 Mental Illness

Generally, contracts entered into by people with mental disorders are valid. The contract can be voided, however, if the individual was unable to understand the nature of the contract and the other party to the contract was aware of this. Where the individual's mental state is such that his or her affairs are under the control of the court any contracts purported to be made personally by the individual will be unenforceable against him or her.

2.2.3 Intoxication

The rules that apply to a person who is drunk are similar to those applying to mental illness. A drunken individual can avoid a contract only if they were so confused at the time that they did not understand what they were doing and the other party to the contract was aware of this.

Summary

There are three main circumstances that can impact contractual capacity and these were outlined in this short Chapter: age; mental capacity and intoxication. It is also worth mentioning that language understanding can be an important factor in some cases.

Self Test Questions

- What conditions must be present for any contract to be valid?
- Does utmost good faith still apply to insurance contracts?
- What is financial underwriting?

CHAPTER 3

Bankruptcy and Insolvency

INTRODUCTION

Most financial advisers will at some time be involved with clients who have either become bankrupt or insolvent and are in serious financial difficulties. It is, therefore, important to have a basic understanding of the rules for individuals who become bankrupt and for companies (or individuals) facing insolvency. Insolvency is the inability of an individual or company to pay all debts when due and may only be temporary. Bankruptcy is a legal status and can be regarded as the final stage of insolvency for an individual. Liquidation is the final stage for a company (but see 3.2 below).

3.1 INSOLVENCY/BANKRUPTCY OF AN INDIVIDUAL

Bankruptcy is one way for an individual to deal with the debts and financial commitments they cannot pay. Where an individual becomes bankrupt nearly all their assets are taken and shared among their creditors: assets which are not taken are tools and vehicle required to work and household items of reasonable value. However, when he has formally been discharged from bankruptcy, the individual will be largely free from debts and will be able to make a fresh start.

As an alternative to bankruptcy, which seriously affects an individual's credit rating, a debtor might be able to make an Individual Voluntary Arrangement (IVA), established by and governed by Part VIII of the Insolvency Act 1986. IVAs enable a debtor to make arrangements, via an insolvency practitioner, with his or her creditors whereby the creditors may accept payments that are delayed or are less than their full entitlement. 75% of creditors need to agree to the IVA and if so it is binding on all creditors. The debtor will retain greater control over his affairs, and especially his home and possessions, if he is not made bankrupt, while creditors may be willing to accept these arrangements if it means that they are likely to recoup a higher percentage of their debt than if the individual becomes bankrupt. It is not unusual for people to be late with agreed payments and it is usually very straightforward to reschedule payments with the creditor. Debt Management Plans and Administration Orders may also be used as alternative arrangements but the details of these are outside the scope of the course.

For debts less than £20,000, a Debt Relief Order may also be used to wipe out debts (there are exceptions like student loans) after a 12-month period if the debtor's circumstances remain unchanged e.g. he does not get a better job. Debt Relief Orders are available to a person who does not own a house and has no spare income. They do adversely affect a person's credit record.

If alternative arrangements are not used then bankruptcy proceedings could ensue. A Court makes a bankruptcy order only after a bankruptcy petition has been presented. It is usually presented either by the debtor (debtor's petition) or by one or more creditors who are owed at least £5,000 (increased from £750 on 1 October 2015) and that amount is unsecured (creditor's petition). This is governed by the Insolvency Act 1986 as amended by the Enterprise Act 2002. Before the Court will make a bankruptcy order it will be necessary to prove the debtor's inability to pay by showing that a statutory demand has not been complied with within three weeks.

Once the bankruptcy order has been made, the official receiver will initially take control of the debtor's property and will act as the debtor's trustee in bankruptcy unless an insolvency practitioner is appointed. The trustee's function is to realise and distribute the bankrupt's assets in accordance with the Insolvency Act 1986. All of the debtor's assets at the date of the bankruptcy order and acquired during bankruptcy will pass to the trustee.

Bankruptcy normally continues for a maximum of 12 months (an IVA can continue for a much longer period, perhaps five years), and the individual will be automatically freed from bankruptcy (known as "discharged") after a maximum of 12 months. However, where the individual has not carried out his or her duties under the bankruptcy order, the trustee may ask the court to postpone the discharge from bankruptcy.

Also, if the official receiver or trustee decides that the individual has been dishonest either before or during the bankruptcy or that he is otherwise to blame for his position, they may apply to the court for a bankruptcy restrictions order. The court may make an order against the individual for between two and 15 years and this order will mean that the individual continues to be subject to the restrictions of bankruptcy.

The Individual Insolvency Register (IIR) is an amalgamation of the individual insolvency, bankruptcy restrictions and debt relief restrictions registers, including trading insolvencies and IVAs. The Insolvency Service is required by statute to maintain these registers, keep them up to date and make them available for public inspection. The IIR contains, inter alia, details of:

- bankruptcies that are current or have ended in the last 3 months
- debt relief orders that are current or have ended in the last 3 months
- current individual voluntary arrangements.

Bankruptcy and Pensions. If an adviser has a client in this situation, particular care is needed and most probably it would be wise for the adviser to quickly refer any client who is bankrupt or even if he has been bankrupt to his lawyer on that aspect.

It is the duty of the trustee in bankruptcy to realise whatever assets he reasonably can for the creditors. Given also the potential availability of significant sums arising from pensions freedom, the existence of substantial pensions rights even for a recently discharged bankrupt could be a potential asset that the trustee would seek to obtain. In the case of *Re Landau* the High Court held that rights under a s226 pension policy formed part of the bankruptcy estate. At the date of the bankruptcy Mr. Landau was entitled to a pension, payable in the future at age of 65: he was 61 when the bankruptcy order was made and 64 when it was discharged. The trustee claimed the entitlement to elect under the policy to commute part of the annuity for a tax free lump sum and then to take that lump sum and the reduced annuity as part of the bankrupt's estate. The Court accepted the trustee's claim.

Concerns were raised because it was felt that *Re Landau* would leave bankrupts of retirement age unable to provide for themselves upon retirement. In response to such concerns the Welfare Reform and Pensions Act 1999 (WRPA) reversed the decision in *Re Landau* removing those pension rights from the bankruptcy estate. Interestingly at the time it was believed that the trustee in bankruptcy's right could only apply in cases where contractual rights were held over the pensions policy assets: in other words DB benefits written in trust could not be taken by the trustee.

Despite the existence of and intention of this legislation (not to leave a bankrupt without support in retirement) the case of *Raithatha v Williamson* (2012) effectively reversed the WRPA. The bankrupt, Mr. Williamson, had reached his pension scheme's pension age but continued to work. He had no intention of drawing pension but had he done he was entitled to an income of between £23,000 and £43,000 per year together with a lump sum nearing £250,000. The trustee in bankruptcy applied for an Income Payments Order and sought the maximum period (under an IPO) of three years of income plus the lump sum, notwithstanding the fact that Mr. Williamson did not wish to elect to draw benefits. While the Court accepted that the right to elect did not pass automatically to the trustee it determined that the trustee could compel such an election. Permission to appeal was granted. However, the parties reached a settlement prior to the appeal on terms that remain confidential, and the appeal hearing was vacated.

Perhaps mindful of the "success" in *Raithatha* a further case has arisen: *Horton v Henry*. Mr. Henry was declared bankrupt in 2012. His assets included four pension policies but, although entitled to take benefits, he decided not to do so and so they remained uncrystallised. The trustee in bankruptcy wished to use the arguments from *Raithatha* to enforce Mr. Henry to take benefits the proceeds of which could then be repaid to the creditors. This was not accepted by the Court and the case went to Appeal: after delays the Court's decision was given in October 2016: it was decided that the trustee in bankruptcy could not compel an individual to crystallise pension rights.

Whether further cases will follow remains to be seen. Whatever, it is likely that the Court would be reluctant to ignore the reasonable domestic needs of the bankrupt and his family. This was the specific point considered in *Re X (Application for Income Payments Order)* (2014). This involved a personal pension worth about £100,000. Assuming the bankrupt took a lump sum this would have left an income of £4,103 (£5,474 if the 25% tax free lump sum was not taken. It was adjudged that this together with the bankrupt's other income (State pensions and housing benefit) resulted in a significant shortfall below the reasonable domestic needs. The Court declined to make the Income Payments Order since it would reduce the bankrupt's annual income below her living requirements indefinitely and not just for the maximum three year duration of an Income Payments Order. In this decision, the Court ostensibly was protecting the bankrupt's assets from creditors: but ultimately if the bankrupt's reasonable domestic needs had been prejudiced by the imposition of an Income Payments Order, the State would have needed to step in to support the bankrupt and her family. We can expect the Court to protect the public interest!

The interaction between bankruptcy and personal pensions and reasonable living standards is extremely complex. The Courts clearly have had difficulty in deciding and consequently, even though the decision in *Horton v. Henry* has introduced some clarity for the time being, if any client of an IFA is involved in bankruptcy then the implications are best left to the lawyers. One course still open to the trustee in bankruptcy is to challenge the payment of excessive contributions to a personal pension in the year or so before bankruptcy occurred.

3.2 INSOLVENCY/LIQUIDATION OF A COMPANY

Insolvency applies when a company cannot pay its debts when they become due, or its liabilities exceed the value of its assets, or both. In this situation it is common for a company to go into liquidation. (Note that a company can go into liquidation for reasons other than insolvency including: reconstruction, fulfilment of original objectives, retirement of main director and shareholder.) Liquidation is the process by which the existence of a company is brought to an end and a liquidator is appointed. The liquidator's role is to realise the company's assets, pay the fees and charges arising from the liquidation and share out any remaining funds to the creditors. In very rare instances a surplus may be available for distribution to shareholders. The company is then dissolved and removed from the Register of Companies.

Alternatives to liquidation include:

- *administration* – where an administrator is appointed to run the company with the aim of rescuing the company as a going concern. Where this is not possible he may be able to achieve a better result for the creditors of the company as a whole than would be achieved in an immediate winding up.
- *voluntary arrangements* – these allow a financially troubled company to reach a binding agreement with its creditors about payment of all, or part of, its debts over an agreed period.

Summary

This Chapter has considered what might happen if either an individual or a company cannot meet agreed financial obligations.

Self Test Questions

- Why might an IVA be advantageous to both a debtor and a creditor?
- What are a company's alternatives to liquidation?

CHAPTER 4

Property Ownership

INTRODUCTION

In England and Wales the two main types of property ownership were “freehold” and “leasehold”. However the Commonhold and Leasehold Reform Act 2002 introduced a new form of ownership for flats known as “commonhold”.

4.1 FREEHOLD

If a property is freehold it means that the individual owns the property and the land on which it is built outright (subject perhaps to restrictive covenants). A freehold property remains the property of the owner until he decides to sell it or dies. When the owner dies, it is part of his or her estate and can be bequeathed to his or her heirs.

4.2 LEASEHOLD

Under a leasehold agreement, the land on which a property is built is not owned outright by the owner of the property. Instead it is leased to the property owner for the period stated in the lease. The leaseholder pays a ground rent to the freeholder. The land and any property on it would revert to the freeholder who owns the land outright when the lease expires. The length of a lease diminishes over time; its initial term is typically for 99 years although leases do exist for up to 999 years. The duration of the lease purchased has a direct bearing on a property's value.

4.3 COMMONHOLD

This new system of ownership for flats was introduced in 2004. Under commonhold, owners of the flats are called unit-holders and they own their flats in perpetuity. Land is commonhold land if:

- (a) the freehold estate in the land is registered as a freehold estate in commonhold land,
- (b) the land is specified in the memorandum of association of the commonhold association as the land in relation to which the association is to exercise functions, and
- (c) a commonhold community statement makes provision for rights and duties of the commonhold association and unit-holders (whether or not the statement has come into force).

The commonhold association owns the freehold of the building and is responsible for maintaining the common parts. The unit-holders must agree to certain terms and conditions (usually similar to those of a lease).

Perhaps surprisingly commonhold ownership has been little used. This could be because developers still prefer to be able to retain the freehold to sell for ground rent income (which can come with significant built-in increases) or because solicitors and lenders have not yet much experience in dealing with this type of property ownership. By way of contrast, in Scotland it has been possible for decades to own the space occupied by a tenement: the title deeds stipulate common ownership rights and shared obligations for walls, roofs etc. Similar arrangements for outright ownership of specific areas but with shared obligations for common areas exist outside the UK: condominiums in the United States and strata property ownership in Australia (and other countries which have copied Australia's system).

4.4 SHARED OWNERSHIP

Property (as with other possessions), as well as on an individual basis, can be held under:

- joint ownership, or
- shared ownership.

Joint ownership can operate in one of two ways, joint tenancy or tenancy in common, but in each case the beneficial owners are as much entitled to possession of any part of the property as each other. It is important in advising clients to know the basis of joint ownership: this can affect financial planning considerations.

Under a joint tenancy neither can sell without the other's agreement and each has an equal share in the property. When one of the owners dies, the survivor inherits his or her share of the property without the need for probate and regardless of any provisions of any Will. This type of tenancy is commonly used by husbands and wives.

Under a tenancy in common each owner holds their share separately and they do not need to be equal shares. Each share in the property can be disposed of as the owner wishes and when he dies the share in the property goes to his estate. This form of joint ownership can sometimes be used by wealthy people to transfer money down the generations in segments which fall within the IHT nil rate band. It can also be used by friends who would otherwise find it difficult to get on the housing ladder if they were buying alone.

Shared ownership are schemes operated by housing associations which allow a purchaser to buy a share in a property, usually 25%, 50% or 75%, while paying a rent to the housing association for its share of the property: the scheme is called Help to Buy: Shared Ownership. The purchaser will then be able to buy additional shares in the property from the housing association over time until they eventually own 100% of the property. Shared ownership properties can be sold, with the new owner taking on the existing owned/rented split and being given the option to increase their ownership as above. Modified versions of the scheme are available to the over 55s and for people with disabilities.

4.5 TENURE AND MORTGAGES

Assuming that all the other lending conditions are met, the type of ownership can have a bearing on how easy it is to obtain a mortgage on a property.

In the case of a freehold property, there should be no difficulties arising from this type of ownership. Mortgage lenders, however, like there to be at least 25 years and up to 50 years left on a lease at the end of a mortgage term before they will lend on a leasehold property. This can mean that it will be difficult to secure a mortgage on a property with less than say 75 years left on a lease. A lender will also want to be satisfied that there is a clear and legally binding agreement concerning the financial responsibility for repairing and maintaining the building.

To overcome the difficulties of short leases, a leaseholder has the right to either extend the lease or buy the freehold. The right to extend or buy a lease was first conferred by the Leasehold Reform Housing and Urban Development Act 1993. Under the Commonhold and Leasehold Reform Act 2002, a leaseholder has the right to buy or extend the lease if they have lived in the property for at least two years and the lease is for a period of 21 years or more.

Summary

This Chapter has considered the three main types of property ownership in England and Wales and how shared ownership can operate.

Self Test Questions

- What are the three main types of property ownership in England and Wales?
- How does a tenancy in common differ from a joint tenancy?

CHAPTER 5

Wills and Intestacy

INTRODUCTION

The distribution of a person's estate after death is governed either by their latest Will or by the laws of intestacy if they have not made a valid Will.

5.1 WILLS

A Will is a legal declaration of how an individual wishes to dispose of their property on death. In order for it to be valid it must comply with certain requirements. Generally, anyone over the age of 18 and of sound mind can make a Will, but there is an exception where Wills can be made by members of the armed forces under the age of 18.

For a Will to be valid it must be in writing and should appoint someone to carry out the instructions, an Executor, to dispose of the individual's possessions and any property. It must be signed by the individual making the Will, the Testator, or signed on the Testator's behalf in his or her presence and by his or her direction. This must be done in the presence of two witnesses who then sign the Will in the presence of the Testator, the whole process being referred to as attestation

It is advisable that any Will should be reviewed regularly to ensure that it still meets the Testator's requirements as circumstances change, e.g. having children. Changes can be made via a codicil. This is a document that makes changes to a Will but does not usually revoke the Will. A codicil is drawn up and executed in the same way as a Will.

The role of the Executor (also known as a personal representative or legal personal representative) is to ensure that the Will is carried out as specified. An Executor (sometimes called an Executrix if female) can be a person or company and there may be a maximum of four Executors. An Executor has to carry out certain tasks in order to legally fulfil the obligations of the task, these include administering the estate, collecting debts, paying any tax due and distributing the assets to the Beneficiaries listed in the Will.

Once the Executor has ensured they have the last original Will of the deceased, they will need to locate all the heirs and make an exhaustive list of all the assets of the estate, from personal to real property, to bank accounts, investments etc and also all the debts including credit cards, utility bills, loans etc.

The Executor is responsible for declaring the value of the estate to HMRC on an Inheritance Tax return, within 12 months of death. This will allow HMRC to calculate whether any Inheritance Tax is due. The Executor is responsible for paying any Inheritance Tax necessary.

The Executor will also need to contact the local Probate Registry to obtain the Grant of Probate which allows them to administer the estate.

Once any tax has been paid and the Executor has obtained the Grant of Probate they can distribute the assets as specified in the Will. However, the Inheritance (Provision for Family and Dependants) Act 1975 provides protection for people who have been financially dependent on the deceased, e.g. spouses, children, civil partners, cohabitants and other surviving dependants who have been left to cope without sufficient money to enable them to get by. In this situation they can apply to the court to claim "reasonable financial provision".

The Testator can revoke his or her Will at any time by destroying it or by making another Will cancelling all previous Wills. Also, getting married or entering into a civil partnership after a Will is made will generally revoke it unless the Will says it will not.

Divorce or dissolution of civil partnership also affects a Will, but does not revoke it. If the Testator divorces or dissolves a civil partnership after a Will is made, any reference to the former spouse or civil partner will be treated as if he had died on the day that the decree absolute or final dissolution order was made. Where the spouse or civil partner has been appointed as an Executor, this appointment will be cancelled by a divorce or dissolution of civil partnership.

If an individual revokes a Will without making a new Will, he or she will die intestate.

5.2 INTESTACY

If the deceased person's Will is invalid or if he dies without making a Will, any property or possessions are distributed in accordance with the Intestacy Rules. The Intestacy Rules are set out in the Administration of Estates Act 1925 as amended by the Inheritance and Trustees Powers Act 2014 (ITPA 2014) and they determine who is entitled to inherit from an estate if the deceased person does not leave a valid Will.

It remains necessary for a personal representative to administer the deceased person's estate in the same way as if there is a Will. This person will need to apply to the Probate Service to obtain a Grant of Representation known as Letters of Administration. Once this has been granted the person will become the Administrator (sometimes called an Administratrix if female) to administer the deceased person's estate.

The role of the Administrator is the same as an Executor to a Will. Once any Inheritance Tax due has been paid, the personal representative will distribute the deceased person's estate according to the intestacy rules. These are shown in the following box.

| Surviving relatives of the deceased person | Inheritance after the payment of funeral expenses, tax and all other debts owed by the deceased person |
|--|---|
| Spouse/civil partner but no children | Spouse/civil partner inherits entire estate. Prior to 1 October 2014 parents, or siblings if no parents, could receive the excess value above £450,000 (with spouse receiving chattels in any event) |
| Spouse/civil partner and children | Spouse/civil partner inherits personal chattels (e.g. car, furniture, clothes etc) plus the first £250,000 (£125,000 for deaths prior to 1 February 2009). Half of the rest is shared equally amongst the children (taking possession at age 18 if relevant or on marriage if prior to 18), with the spouse/civil partner getting the other half outright. Prior to 1 October 2014 the spouse received the income or interest on the "other half" during his/her lifetime. |
| No spouse/civil partner | HMRC's Inheritance Tax Manual sets out the order of inheritance if the deceased had no surviving spouse or civil partner: <ul style="list-style-type: none"> • children (including where parental control was present) • parents - equally if both living • brothers and sisters of the whole blood - equally and their issue per stirpes • brothers and sisters of the half-blood - equally and their issue per stirpes • grandparents - equally if more than one living • uncles and aunts of the whole blood - equally and their issue per stirpes • uncles and aunts of the half-blood - equally and their issue per stirpes • The Crown, Duchy of Lancaster or Duchy of Cornwall (as ownerless assets known as Bona Vacantia and administered by the Treasury Solicitor on behalf of the Crown; there were over 15,000 such ownerless intestate estates listed in October 2015). <p>(if property is to be divided 'per stirpes' among the children of a deceased person, then each child takes an equal share. If a child has died before the deceased that child's children will take the share their parent would have taken equally between them)</p> <p>The rules provide that any Beneficiary qualifying within a particular category excludes anyone from a lower category qualifying for benefit.</p> <p>The rules also provide that, like the deceased's issue, the brothers and sisters and aunts and uncles (or their issue where appropriate) do not take vested interests until they reach the age of 18 or marry.</p> |

Notes:

1. The spouse/civil partner needs to survive for 28 days before inheriting.
2. An adopted child is treated as the legitimate child of the adopter(s).
3. A child legitimated takes any interest as if born legitimate.
4. An illegitimate child takes any interest provided there is satisfactory proof of parentage.
5. The property of a man or woman who is divorced or legally separated does not go to the ex-spouse under the intestacy rules.
6. All relatives above should be blood relationships (so the wife of an uncle bearing the courtesy title aunt cannot take any benefit under the intestacy rules).

Applying for financial help

Even where a person is neither married to the deceased nor named in any Will - perhaps because of intestacy - it is still possible to apply to the Court for reasonable financial help from the estate of the person who has died intestate. As examples: a person falling into the above category had lived with the deceased for at least two years immediately before their death; a person who had been treated as a child of the family.

Summary

This Chapter has looked at what happens on an individual's death, the role of a Will, when a valid Will might cease to apply, the effect of divorce and the priority of Beneficiaries in event of Intestacy.

Self Test Questions

- What is required for a Will to be valid?
- What is the difference between an Executor and an Administrator?
- What are the intestacy rules for the distribution of an estate where there is no valid Will?
- Was the surviving spouse's share of an Intestate's Estate improved or worsened from 1 October 2014?

CHAPTER 6

Trusts

INTRODUCTION

Since the Middle Ages, when the concept of a Trust was developed, Trusts have been used in a variety of different contexts including Wills, charities, passing wealth onto future generations and as the vehicle for occupational and personal pension schemes. Usually a Trust is created by a person known as the “Settlor” (in the context of a pension trust this will be the employer or provider which originally established the Trust) and the Trust is run by Trustees who administer the Trust and invest the trust property for the benefit of the Beneficiaries identified in the trust deed. Trusts can arise incidentally to another event: these are constructive trusts (explained further below).

Trust law imposes a number of onerous duties on Trustees, which stem from the fact that Trustees are responsible for taking care of and investing the trust property on behalf of others. When discharging their duties, Trustees need to ensure that they comply with the legislation and case law that is relevant to the Trust for which they act. Where Trustees fail to comply with their legal duties or the legal requirements that apply to their scheme, they may be held personally liable for any loss which is suffered by the Trust as a result.

This Chapter describes some of the basic principles of trust law, including the main features of a trust; how to create, vary and terminate a Trust and the role of Trustees and potential liabilities of Trustees for breach of trust. We finish the Chapter off by comparing Trusts with contracts.

6.1 THE MAIN FEATURES OF A TRUST

The main features of a Trust are:

- there is a separation between the legal owner of the trust property and the person or persons who have the benefit of it, i.e. the Trustees are the legal owners of the trust property and the Beneficiaries under the trust have the benefit of it;
- the Trustees must use the trust property in accordance with the purpose for which the trust was created, according to the terms of the trust (the purpose of a pension scheme often being described as the provision of retirement benefits) or in line with statutory requirements if the trust wording is silent on significant operative matters. Note also that some trusts, for example MWPA, derive their powers and structure from statute, specifically in this case s11 of the Married Women’s Property Act 1882 designed to allow married women to leave the proceeds of their policy to specified beneficiaries such as children;
- trust property is separate from both the Trustees’ private property and the property of the person who created the trust (the “Settlor”); and
- a trust can be enforced only by the Beneficiaries unless the Settlor specifically reserves the right to enforce the trust when it is created.

Modern trusts have many commercial uses such as for establishing collective vehicles like Unit Trusts (but not OEICS, they are differently structured) and debentures, for keyman protection purposes and for the more traditional uses, including charities and family settlements. The above (bullet-pointed) features also make a Trust well suited for occupational pension provision, because the Trustees must hold and invest the scheme assets to provide benefits for the members (who can enforce the Trust), and those assets are separate from the assets of the sponsoring employer, which means that they are secure (and cannot be accessed by the employer's creditors) even if the employer becomes insolvent. Similar considerations apply under personal pensions whereby the trust structure (which can also be provided by a bespoke individual trust as well as the provider's master trust) provides protection from creditors as far as the member is concerned and facilitates transfer, probably tax-free in the event of the member's death, to his spouse or children or other Beneficiaries.

6.2 TRUST CREATION AND THE THREE CERTAINTIES

Trusts are usually established by a written document, such as a trust deed or Will. They can be either:

- Private Trusts - trusts for the benefit of an individual or class of persons; or
- Public Trusts - trusts established for an educational, human rights, relief-of-poverty or other charitable or public interest purpose.

In order for a trust to be valid three conditions must be satisfied, as first established in *Knight v. Knight* 1840. Three "certainties" must be present:

- certainty of intention - the Settlor must show a clear intention to create a trust
- certainty of subject matter - the trust property must be clearly identified or identifiable; and
- certainty of 'objects' - the Beneficiaries of the trust and the benefits that they are to receive must be certain. If a class of persons are the Beneficiaries (as in a pension scheme), the definition of that class of persons must be clear so that a Court is able to decide whether any given claimant falls within that class or not. However, it is not necessary to be able to identify all members of the class at any particular time (e.g. an unborn dependant).

Trusts may be created in the following ways:

Express Trusts – these are intentionally created by a person out of his right of ownership. The person who creates an express trust is usually referred to as the Settlor, even when the trust is not strictly a settlement. Express Trusts are typically created in the form of a written document, the "trust instrument".

Statutory Trusts – these arise by virtue of the application of a particular statute, e.g. trusts created during bankruptcy proceedings or where a person dies intestate. In the latter case the Intestacy Rules (see previous Chapter) come into operation as required by Statute.

Implied Trusts – these can be split (*Re Vandervell's Trusts (no.2)* [1974]) into 'presumptive' and 'automatic'. They are implied because no express declaration of trust has been made by the Settlor. A presumptive implied trust (a resulting trust) arises when a Settlor transfers property for a Beneficiary, and when, perhaps because Beneficiary dies before the trust property is used, the balance of the trust property reverts ("results back" in legal parlance) to the Settlor or his estate. An implied automatic trust arises when a Beneficiary cannot be adequately identified, perhaps when the reason for which they were established ceases to apply, for example in the case of disaster relief.

Constructive Trusts – these are created by a Court where title to property is vested in a person who should not be permitted to retain it. The Court uses a constructive trust and compels the defendant to convey the title to the property to the rightful owner. It treats the defendant as if he were a Trustee from the date the unlawful holding of the trust property commenced.

This section has considered ways in which trusts can be created. We look at the different types of trust which can be created in section 6.5 below.

6.3 TRUSTEE DUTIES

The duties of pension scheme Trustees stem from:

- general trust law principles which have been developed by the Courts (and which apply to Trustees of all trusts);
- statute; and
- the terms of the trust deed itself.

Overarching Duty: the overriding duties of a Trustee are to act in the best interests of the Beneficiaries and to safeguard the property of the trust, all in accordance with the purpose of the trust and to exercise the powers and discretions set out in the trust to correctly discharge that overarching duty.

Note that this overarching duty for a pension scheme has been considered by the High Court in the recent Merchant Navy Ratings case: *Merchant Navy Ratings Pension Fund Trustees Ltd v Stena Line Ltd and others* [2015] EWHC 448 (Ch). The complex deliberations of the Court concluded that the overarching duty is to administer the pension scheme in accordance with the primary purpose for which the scheme was established i.e. to secure the benefits - the scheme here was in deficit and the Trustees were seeking ways of reducing this deficit by asking former participating “historic” employers to contribute towards the deficit reduction, which the historic employers argued was outside their remit.

In general the Trustees’ role, more specifically, is to:

- deal with the assets according to the Settlor’s wishes, as set out in the trust deed or their Will
- manage the trust on a day-to-day basis and pay any tax due
- decide how to invest or use the trust’s assets.

6.4 GENERAL POWERS OF TRUSTEES

In order that the duties of Trustees may be properly discharged, the trust deed must provide Trustees with power to act. The general position under trust law is that in exercising these powers, the Trustees must act unanimously unless there is provision to the contrary in the trust deed (the latter may be met with in pension schemes). Trust deeds prepared for financial planning purposes may stipulate that the “First Trustee” who will in all probability also be the Settlor must always sign together with one other Trustee, who for financial planning trusts may also be a Beneficiary and the spouse of the Settlor. Note however that this position will tend to change as the Settlor of a family trust grows older and the children gradually assume prime fiduciary responsibility. Indeed when the financial adviser is reviewing a client’s affairs it is good practice to consider the current suitability of Trustees: a Settlor-Trustee in his 90s might no longer be the best person to be the main Trustee whose signature is required for every trust operation. With luck, he will be too busy enjoying himself in the Caribbean and it will be time for his children and grandchildren to take over the fiduciary role!

Some of the most important powers that you would expect to find in a trust deed include (depending on the purpose of the trust) the power to:

- amend the trust deed and rules of the scheme;
- appoint and remove Trustees;
- invest the scheme assets;
- buy annuities in order to secure members’ benefits;
- accept transfer payments.

Some powers of a pension trust will be vested in the scheme's principal employer to enable it to exercise some degree of control over the operation of the scheme (e.g. the principal employer may retain the power to amend the scheme). Alternatively, a power may be vested in the Trustees alone or it may be a joint power (i.e. where the consent of the Trustees and the consent of the principal employer are required to exercise the power).

6.5 TYPES OF TRUST

Over and above public trusts, such as The National Trust or other charitable bodies, which are established for the benefit of the public in general (and enjoy tax privileges re donations for example), trusts can be created for specific individuals or class of individuals. Trusts set up for the benefit of specific individuals are generally private trusts and it is private trusts with which the adviser could become involved. Types of private trust – and these are generally Express Trusts created for a specific purpose – include:

Bare Trusts – in a bare trust (sometimes known as an absolute or simple trust) the sole duty of the Trustee is to transfer the trust property to the appropriate Beneficiary. Once the trust has been set up, the Beneficiaries cannot be changed. The assets are held in the name of a Trustee, but the Trustee has no discretion over what income or capital to pass on to the Beneficiary or Beneficiaries. Bare trusts are commonly used to transfer assets to minors such as grandchildren.

Interest in Possession Trusts – an interest in possession trust is one where the Beneficiary is entitled to trust income as it arises. The Beneficiary who receives the income may or may not, have any rights over the capital held in the trust. The capital may pass to a different Beneficiary or Beneficiaries in the future. The Trustees might have the power to pay capital to a Beneficiary even though that Beneficiary only has a right to receive income. However, this will depend on the terms of the trust. For example, where a husband dies he might leave a trust which gives his surviving spouse income from the trust property for the rest of her life, but when she dies the trust ceases and the capital passes to the children.

Discretionary Trusts – a discretionary trust is one where Trustees have “discretion” about how to use the income of the trust, and sometimes the capital. The Trustees are the legal owners of any assets held in the trust and are responsible for running the trust for the benefit of the Beneficiaries. The Trustees have “discretion” about how to use the trust's income and may also have discretion about how to distribute the trust's capital. Trustees may be able to decide:

- how much income and/or capital is paid out, if any
- which Beneficiary to make payments to
- how often the payments are made
- what, if any, conditions to impose on the recipients.

The extent of the Trustees' discretion depends on the terms of the trust deed. Pension schemes use the discretionary trust format.

(Note: the above three classifications cover the main types of private trust. Other “types” are considered below but in practice they could be “re-classified” into one of the above three categories.)

Accumulation Trusts – an accumulation trust is one where the Trustees have the power to “accumulate” income (add it to capital). They will often do so until the Beneficiary becomes legally entitled to the trust assets (such as money, land or buildings) or the income produced from the assets. Income that has been “accumulated” becomes part of the capital of the trust. The Trustees may also pay income at their discretion: Accumulation and Maintenance trusts.

Settlor-interested Trusts – these are also known as settlements and are not a type of trust in their own right, but will be either an interest in possession trust, an accumulation trust or a discretionary trust. If the Settlor or their spouse or civil partner may benefit from income or gains from assets held in a trust, it is regarded as a Settlor-interested trust.

Employee Benefit Trusts – employers can set up schemes for the benefit of their employees. These schemes are often funded through a trust. There are several types. The main ones are:

- general employee benefit trusts, i.e. contributions are used to provide general benefits or bonuses, sick pay or medical expenses, education or training
- employer financed retirement benefits schemes (EFRBs), i.e. the employer makes contributions and the Trustees pay out benefits when a member retires or dies
- employee share scheme trusts, i.e. companies set up a share plan via a trust to buy shares for the benefit of employees.

Other “classifications” of trust may be met with (e.g. parental trusts, non-resident trusts, trusts for vulnerable people) and it is important for the adviser to understand the nature of the trust with which he is dealing since the treatment of Capital Gains Tax and Income Tax can differ significantly between trusts. The nature of the trust will depend on its precise wording and there have been many Court cases which have been the subject of tax disputes. The adviser needs to take particular care in this area. Legal input is often required and is certainly desirable in formulating adequate wording

6.6 BENEFICIARIES

We have already mentioned Beneficiaries as one of the three certainties a trust must possess. A Beneficiary is anyone who benefits from the assets held in the trust. There can be one or more Beneficiaries, such as a whole family or a defined group of people. They may be specified by name e.g. my wife, Elizabeth Smith and my children Charlotte Smith and Jason Smith. Or they can be identified as a class “my wife and children”. A combination could be used (allowing also for example for specific circumstances): “my wife, Elizabeth Smith and in the event of her prior death, my children”. It is usual for deeds to stipulate a number of classes of Beneficiary, clarifying that natural and adopted children should be Beneficiaries, then grandchildren, then parents, then siblings, then any other blood relative (full or half blood as appropriate). The permutations are many.

Each Beneficiary may benefit from the trust in a different way. A Beneficiary may have an absolute interest, a life interest or a reversionary interest. A Beneficiary who has a life interest is entitled to income from the trust property for life, but cannot touch the capital: this class of Beneficiary may be referred to as a life tenant. When the Beneficiary with the life interest dies the property passes to the Beneficiary (ies) with the reversionary interest: this class of Beneficiary is also referred to as remainderman (men).

6.7 ADMINISTERING TRUSTS

The first duty of a Trustee is to become familiar with the terms of the trust and then to gain control of the trust property. The Trustees must then administer the trust property for the benefit of the Beneficiaries, in the manner set out in the trust. Usually, the trust will give Trustees all the necessary powers to deal with the trust property. Also, the Trustee Act 1925 contains some statutory powers that can be exercised in addition to the powers given in the trust. Section 31, “Power to apply income for maintenance and to accumulate surplus income during a minority”, and section 32, “Power of advancement” (of capital to Beneficiaries) are good examples of this. On the other hand the Settlor may specifically exclude these sections: it depends on his intentions for the trust.

Trustees have a duty to invest money that is not to be paid out immediately and in exercising this duty must use the utmost diligence to avoid any loss. Where they depart from this standard of care, the law will hold them liable for any loss caused by this breach of duty. However, where the Trustee is exercising a discretion rather than a duty the standard of care is to act with the diligence a prudent man of business would use managing his own affairs.

Trustees must also keep proper accounts of the trust property and these must be produced and shown to the Beneficiaries if required. In general, the Trustee of an express trust has a fiduciary duty to the Beneficiaries, and the Beneficiaries can seek to enforce that duty in the courts.

Generally, anyone age 18 or over who is legally capable of holding property can be a Trustee. Trustees will be removed from trusteeship, or the trusteeship will end, when:

- the Trustee resigns or die
- the Trustee is removed or automatically retired under the provisions of the trust deed
- the Trustee is removed by the other Trustees (if allowed under the trust deed)
- the Trustee is removed in accordance with the Trustee Act 1925
- the Trustee is removed by a relevant court.

6.8 THE RULE AGAINST PERPETUITIES

It is a rule of trust law that a private trust cannot last forever. In relation to trusts created on or after 6 April 2010 the law states that a trust must terminate within 125 years (regardless of any contrary provision in the trust instrument). The maximum period before that date was 80 years. Pension schemes which are registered with HM Revenue & Customs (HMRC) are generally exempt from this requirement, though the rule may apply to discretionary trusts arising on death, so pension scheme trust deeds usually specify a perpetuity period.

6.9 BREACH OF TRUST

A breach of trust is committed (broadly) when a Trustee acts outside the terms of the trust instrument or fails to discharge his legal duties.

A Trustee who has acted in breach of trust is personally liable for any loss that has been caused to the trust fund as a result of that breach and he may be sued by the Beneficiaries to the full extent of his personal assets. Usually a Beneficiary would claim an indemnity from the Trustee requiring him to make good any loss to the trust fund. In addition, if the Trustee has profited from the breach, a Beneficiary can require payment of the profit into the trust fund.

A Trustee may be held responsible for the acts of his co-Trustees if he has not exercised due care in ensuring that they have properly discharged their duties. Where more than one Trustee is liable for a breach of trust, liability is joint and several, which means that a Beneficiary can claim the complete loss from any one Trustee separately or from all, or several, of them jointly.

Trusts may contain provisions that seek to limit the Trustees' liability for breach of trust. Being a Trustee is an onerous responsibility. A Trustee can be held personally liable to the full extent of his personal assets for:

- his own acts or omissions if he has failed to act with reasonable care and prudence or if he has not acted in good faith;
- losses to the trust fund which result from an act or omission which constitutes a breach of trust;
- the acts of his co-Trustees if he has not exercised due care in ensuring that they have properly discharged their duties.

A Trustee is liable for acts or omissions which occur during his term of office and he remains liable for acts or omissions which occur during that period even after he has been removed from office or resigns. Where more than one Trustee is liable for a breach of trust, liability is joint and several, which means that a Beneficiary can claim the complete loss from any one Trustee separately or all or several of them jointly. Insurance could be considered though this might be unusual if a family member is acting as Trustee of a family trust. Insurance has

the advantage that it offers Trustees the most certain form of protection against liability for breach of trust. However, before taking out insurance, Trustees should consider whether it may prove to be an unnecessary expense which does not provide any greater protection than that already offered by an exoneration clause. Trustees need to consider carefully the terms of the policy and what liability it covers

6.10 VARIATION OF A TRUST

It may be necessary or desirable to amend the provisions of a trust from time to time in order to meet changes in circumstances. There are a number of possible methods for doing this:

- exercising a power of amendment contained in the trust deed, subject to its precise terms
- obtaining the consent of all the Beneficiaries, provided they are not minors or suffering from incapacity
- exercising a statutory power to amend the trust
- obtaining a Court order or other authorisation from the Court to modify the terms of the trust.

6.11 TERMINATION OF A TRUST

A trust may be terminated where the Trustee has distributed its proceeds to the Beneficiaries or where there are express terms under the trust deed which bring the trust to an end.

In addition, where all the actual or potential Beneficiaries are in existence and have legal capacity to do so, they can require all trust property to be transferred to them, bringing the trust to an end. This was established in *Saunders v Vautier* a leading case in English trust law dating back to 1841: the precedent set then remains valid today. However, this will not be possible under a trust where the class of Beneficiaries may change (as is the case with most pension schemes) or where it is contingent on a particular event occurring.

6.12 DISTINCTIONS BETWEEN A TRUST AND A CONTRACT

In order to appreciate some of the key features of a trust it is helpful to consider the main distinctions between a trust and a contract (a contract being another way in which English law can provide for someone to deal with property for the benefit of others). The main distinctions include:

- a contract is enforceable only if it is made by deed or if it is supported by consideration (i.e. something is given in return for it), whereas a Beneficiary under a trust can enforce the trust even though he has given no consideration
- as long as the Contracts (Rights of Third Parties) Act 1999 is excluded, only the parties to a contract can enforce it, whereas a trust can be enforced only by the Beneficiaries (who will not be a party to the trust instrument) unless the Settlor specifically reserves the right to enforce the trust when it is created
- a trust cannot be terminated as a result of a major breach of trust, whereas a major breach of contract may lead to the termination of the contract
- most trusts, unlike contracts, exist for a long period of time. Consequently, a trust will usually be capable of variation. In addition, the Courts have the power to vary the provisions of a trust instrument and to advise the Trustees on the proper scope of their powers.

Summary

This Chapter looked at a number of legal concepts that are relevant to financial advice including Powers of Attorney and related matters, property ownership, bankruptcy and the use of trusts. Financial advisers need to be aware of these concepts and how they might affect their clients before they make recommendations.

Self Test Questions

- Who or what are the objects of the trust?
- What are the four main ways a trust can be created??
- Describe the main uses of trusts.
- How can a trusteeship come to an end?
- How can a trust come to an end?
- Outline four major differences between a trust and a contract.

PART 5

PENSION TRANSFERS SIPPS AND DRAWDOWN AND CURRENT DEVELOPMENTS

OVERVIEW

This Part deals largely with pensions. In many circumstances, a client's biggest asset is likely to be a pension. Where the client has moved jobs, he or she may have one or more deferred pensions and they may be seeking advice on how best to manage these arrangements.

This Part consists of three Chapters. The first deals with Pension Transfers, the second describes SIPPs and drawdown, while the final Chapter considers current market developments.

CHAPTER 1

Pension Transfers

INTRODUCTION

One of the most infamous financial services scandals of the last three decades is that surrounding pensions transfers. After-shocks still reverberate around the pensions industry today and Regulatory Updates governing pension transfers which were issued 15 years ago remain current. The Daily Telegraph commented: “The pensions mis-selling scandal of the late 1980s rumbles on. More than a million people are thought to have been incorrectly advised to take out personal plans when they would have been better off in a company scheme. Compensation has been paid to hundreds of thousands of people, but not every case has been cleared up. And while the watchdogs have tightened up all the rules on pension selling it is still possible for bad advice to be given.” This was published on 12 July 2014. It could have been published 20 years ago as similar headlines abounded then.

In October 1994, the Securities and Investments Board recommended that financial advisers review all cases where, on the basis of advice given between 1988 and 1994, individuals had transferred from, opted out of or failed to join an occupational pension scheme and had instead taken out a personal pension scheme, buy-out contract or retirement annuity contract. The purpose of the review was to identify any cases where the customer had been disadvantaged by taking this action. Compensation was then to be paid to employees, pensioners or their beneficiaries who were identified as victims of bad investment advice during the relevant period.

The scandal cost the financial services industry much in reputation, compensation, fines and remedial action. The FSA stated in 2002 that the pensions mis-selling scandal cost insurers and financial advisers at least £11.8bn in compensation payments. Yet paradoxically the problem arose in part out of legislation which was designed to give more freedom of choice to pension scheme members. (The student can dwell on whether or not the pensions freedoms permitted from April 2015 will give rise to long-term complaints! And when the student does become an adviser, ensure that their Suitability Letter is prepared in such a way that no such complaints come their way!) From the mid-1970s, successive legislative steps not only loosened the restrictions that defined benefit pension schemes in particular could impose on transfer values but also improved the benefits that could be converted to transfer values. The result was that the late 1980s and early 1990s, after legislation effective from 1 July 1988 opened up the personal pensions market, saw a substantial increase in transfer values paid from defined benefit schemes in particular. While members potentially could benefit from transfer values and the investment freedom which accompanied that (members with self-invested schemes, especially SSAs and to a lesser extent SPPs, were obvious potential beneficiaries), there were individual DB members who had seen their expected pensions, in many cases previously guaranteed by a public sector type of scheme, reduce as annuity rates started to fall given the increase in longevity and the decrease in Gilt yields. There were many headlines at the time about nurses, miners and others who had lost out in terms of their expected pensions as a result of transferring.

Anyone involved in the pensions transfer market today should never overlook this past. And while transfers at that time were made with the member's agreement for reasons which were accepted (by the member) and acceptable (to the industry) at the time, it was the pensions industry which paid a heavy price when the clarity of unimpeachable 20:20 hindsight imposed a different interpretation. Much of the mis-selling problem arose out of the steep decline in Gilt yields and improved longevity. Could that have been predicted in the six years from 1988? Probably not, but the financial services regulator ensured that the individual investor was compensated by the industry. The message is clear: be very careful when advising on pension transfers. A further point is that because pension transfers are complicated, specialist advice is needed. That is why you are studying for the DRRRA: it will give you the appropriate qualification to advise on this complex matter. So, back to the present.

Members can transfer the value of their benefit entitlement from one UK registered pension scheme to another. The receiving scheme can also be an overseas pension scheme and if that overseas scheme meets certain qualifying criteria, there should be no immediate tax disadvantages.

Transferring benefit rights does not mean that members will ultimately get the same benefits in the receiving scheme as they would have had in the scheme they transferred out from; rather a sum of money known as a "transfer value" is paid from one scheme to another. If the transfer is to an overseas scheme the tax treatment of funds and benefits may differ significantly from the position within the UK.

The member will be given a benefit entitlement within the receiving scheme. If the ceding and receiving schemes are defined benefit, the new benefit entitlement may be calculated to deliver similarly-structured benefits at retirement. In this scenario, added years would be granted under the receiving scheme but generally not as many as given up in the ceding scheme. The rationale for this is that the member is joining a new employer and will probably be on a higher salary or expect a higher salary in future (though actuarial caution, in both the ceding and receiving schemes, is another factor). The position where a defined benefit scheme makes a transfer to a money purchase arrangement is even more complex because benefits emerging from the new money purchase contract would depend on further and future variables. For transfers where defined benefits are involved, specialist advice needs to cover off the advantages and disadvantages of accepting the transfer and if there is doubt not only does the member not have to agree to accept the transfer but also the adviser probably should not be recommending any transfer. A transfer from money purchase to money purchase is more straightforward but is not without its complications.

It is crucial, therefore, for the financial adviser to understand all aspects of pension transfers, including the actuarial, investment and administrative requirements involved in any transfer and the roles and responsibilities of those involved in pension transfer issues. It is also important to understand how transfer values are calculated, the influence of transfer incentives and related legal requirements.

This Chapter will analyse the advantages and disadvantages of pension transfers and the implications for all the parties affected by the transfer.

1.1 LEGAL BACKGROUND

Prior to 1975, members of occupational schemes had no statutory rights to preserved benefits or to transfer values. (We consider the improvements to leaving service options elsewhere in the DRRRA course.) Such rights as did exist were conferred by those schemes which decided of their own volition to offer such benefits, often only in redundancy situations. It was felt that any employee leaving of his own free would know what terms his new employer was offering and that it was his responsibility to satisfy himself that he was happy with the new role and terms and that he accepted that the break with his old employer was complete. But subsequent decades have witnessed a dramatic change pushed forward by successive Acts of Parliament and Regulations.

1.1.1 Statutory Right to a Transfer

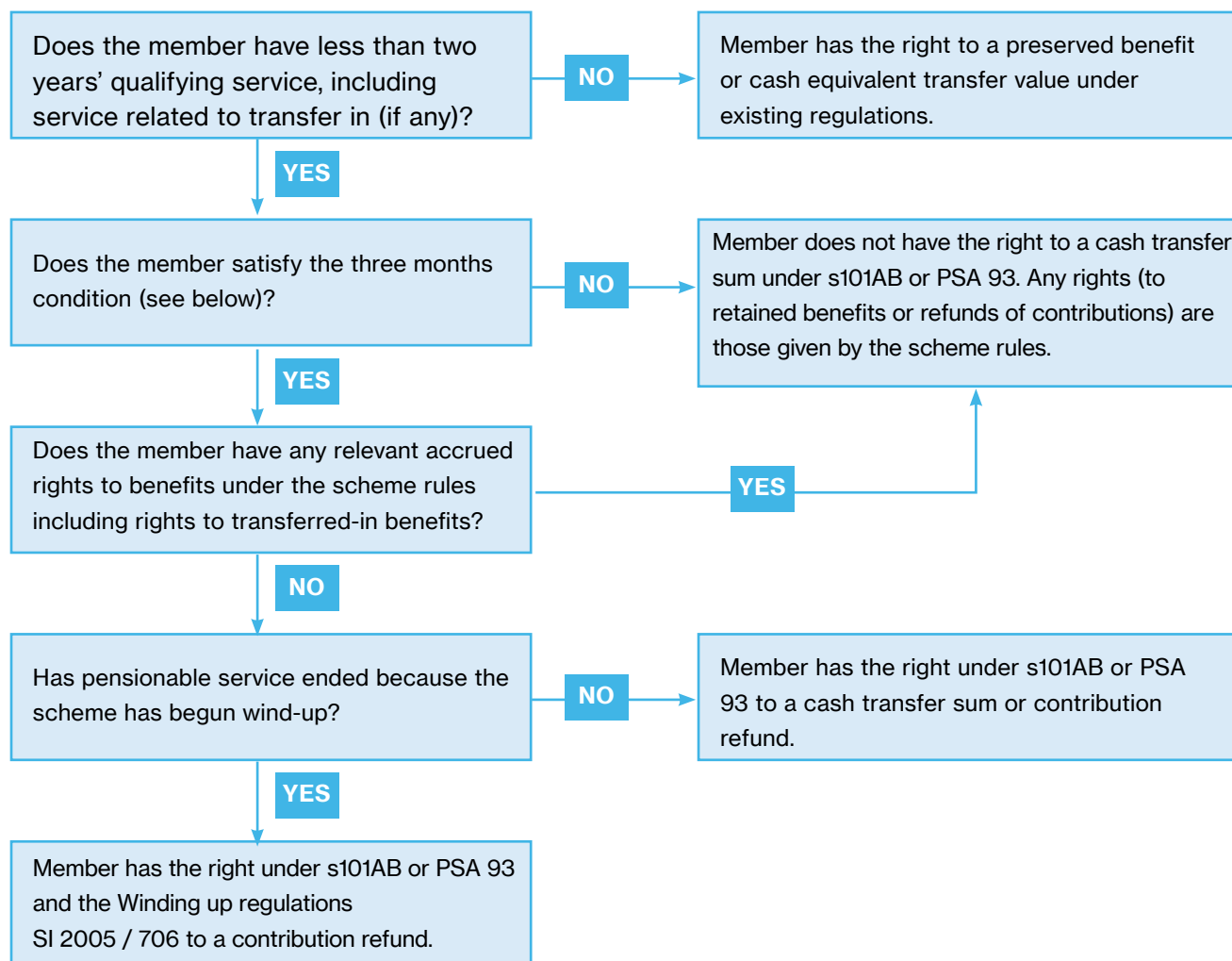
By 1993, the Pension Schemes Act of that year, consolidating certain previous legislation, confirmed (in particular in Chapter IV of Part IV to that Act) the members' statutory right to a transfer value as long as they satisfy the following conditions:

- they must have "accrued rights" (detailed in s20 to the 1993 Pension Schemes Act) in the scheme (which would normally mean the completion of at least two years' qualifying service)
- they must have left pensionable service at least one year before the scheme's normal pension age with the date of leaving pensionable service being after 1 January 1986
- they must transfer all their benefits. (If they are transferring benefits from a DB contracted out scheme to a scheme in which is not contracted out, they must transfer all their non contracted out benefits, subject to acceptable agreements being made re contracted out benefits. Note that subsequent to April 2012 active contracting out applies only to DB schemes and even for those schemes contracting out will cease in 2016. Students should bear in mind that residual policy features harking back to contracting out may still apply with some providers on existing DC contracts.)

For occupational schemes, an additional requirement is that the member has left the employment of the sponsoring company. If the member has not left employment, then he only has a statutory right to a transfer if he opts out of the scheme, and even then the statutory right only applies to the benefits he has accrued after 5 April 1988. Schemes might allow transfers even where a member does not satisfy all of the statutory requirements. This scenario will be met with infrequently nowadays but the adviser should note, if he is dealing with a pensions consolidation exercise, that the position of pre-1988 occupational rights may need special attention (and remember to ensure that pensions consolidation can be demonstrated to be in the client's best interests!).

Since April 2006, the right to a transfer value has been extended to include those who leave the scheme before normal pension age and have at least three months' service but have no accrued rights (i.e. those leaving between three months and two years). Such members can opt to take a transfer value as an alternative to a refund of contributions. If they do not elect to take the transfer value within a reasonable period (usually three months), the trustees can pay the refund by default. This avoids the problem for trustees and insurers of being left with very small benefits that are uneconomic to administer.

The Pensions Regulator (TPR) produces, in its Early Leavers Regulatory Code of Practice No. 4, the flowchart below (it summarises the above points)



This flowchart was first produced in 2006 and now introduces changes with regard to winding-up from later Regulations subsequent to the 1993 Act.

1.1.2 Scheme Administrator

HMRC requires each registered scheme to have an official "Scheme Administrator", often the trustees, who is responsible for carrying out various duties relating to the scheme, such as the payment of transfers on time and making this payment to a registered scheme, in accordance with the Finance Act 2004. The day-to-day administration, however, is usually delegated. If a payment is made to an unregistered scheme then the Scheme Administrator would need to account for the tax due on the payment.

Advisers may find that they are advising Scheme Administrators as well as members. In such a scenario, the adviser would need to consider the requirements of both parties and ensure that they are not advising both at the same time on the same matter where there are potential conflicts of interest.

11.3 Transfers in

When individuals join a pension arrangement, they may have deferred benefits from a previous employer's pension scheme (DB or DC) or from individual arrangements such as a personal pension. Advisers should also be aware of old retirement annuity contracts, sometimes known as s226 arrangements, which pre-dated personal pensions. Different tax rules applied to retirement annuity contracts: briefly, tax free cash was three times the maximum approvable pension. Also, some older s226 contracts were set up on with profits terms with payments on premature death linked to contributions made rather than the return of fund met with on modern personal pension contracts.

Individuals may be able to transfer these deferred benefits, from wherever they arise, into their new pension arrangements, but this will be dependent on whether or not the new pension arrangement is prepared to accept transfers. Given the increasing burdens being added to DB scheme liabilities by successive tranches of legislation, financial advisers should encourage their clients to check the willingness of DB scheme trustees to accept new liabilities from transfers-in before embarking on any potential transfer exercise. Where transfers are accepted into a DC scheme they will become part of the individual's pension pot, while in a DB pension schemes the individual will generally be offered one of the following benefits in return for a transfer payment:

- added service credits, or
- additional pension, or
- a payment into a separate DC arrangement, which arrangement may be set up as section of the main scheme (perhaps in a separate section alongside any Additional Voluntary Contributions) or within a separately constituted scheme run by the trustees or by the employer.

The information required by the adviser and the receiving scheme from the ceding arrangement will consist of:

- the member's personal details
- the name of the ceding scheme
- the type of arrangement (e.g. defined benefit scheme, personal pension)
- confirmation that the scheme is a registered arrangement with HMRC together with the Pension Scheme Tax Reference number (PSTR)
- whether contracted out or not (While this is of declining importance since money purchase contracting out ceased on 5 April 2012 and contracting out under DB schemes ended in April 2016 when the new single-tier State pension is introduced, the structure of many pensions arrangements reflects the old days of contracting-out. The adviser needs to understand this.)
- pensionable service details (for DB schemes) and scheme joining and leaving dates
- details of any protected pre-April 2006 tax free cash rights
- whether the transfer contains a transfer in from a previous scheme and, if so, details of this
- the value of member's benefits and contributions included in transfer, including any AVCs, and the amount of contracted out benefits
- the current transfer value (split out into contracted out and non-contracted out rights) and whether any guarantee period applies to its validity
- a statement of equalisation for pensionable service post 17 May 1990 (if applicable)
- confirmation of any Court orders on the member's benefits (for example earmarking or pension sharing orders, maintenance or bankruptcy orders).

If both the transferring and receiving schemes were contracted out prior to 6 April 2016, additional information will be required including:

- ECON (Employer's Contracting-Out Number) and SCON (Scheme Contracting-Out Number) (ASCNs, or Appropriate Scheme Contracted-out Numbers, ceased to be relevant for personal pensions arrangements when contracted-out ceased for money purchase schemes in April 2012)
- any Guaranteed Minimum Pension (GMP) included and supporting details such as revaluation basis and period of contracted-out service (Protected Rights used to be relevant for money purchase schemes)
- the period of any contracted out service
- if limited revaluation applies to any GMP, if a Limited Revaluation Premium has been paid.

A quotation of the benefits the member could receive from a transfer in must be provided within two months (as set out in Disclosure Regulations) of the trustees receiving all the necessary information to calculate those benefits. This illustration of the benefits to be provided in the new scheme will be forwarded to the member, together with instructions on what the member should do if they wish to proceed with the transfer.

The member will then be able to consider the benefits offered in the new scheme alongside the details of the benefits under the former scheme.

Whilst transfers from a DB scheme will be guaranteed for a period (normally three months), transfers between DC schemes are not guaranteed (except when a guarantee of a few weeks is offered on an old With-Profits policy), as the value of the units to be sold/purchased will vary according to market conditions at the time of transfer. This should also be brought to the member's attention by the transferring scheme.

Rarely do schemes have identical benefits, contributions, terms and conditions, so deciding whether or not to transfer benefits involves a careful analysis of all the different factors. Before any transfer is made between DB schemes the member must confirm that he or she understands the terms and conditions of both schemes and accepts the benefits offered by the transfer value applied under the rules of the new scheme. The member should ask for an adviser's assistance if he has any doubt as to the value of benefits to be ceded and to be received. With DB schemes there will probably be an adviser involved from outset and it is the adviser's job to clarify the advantages and disadvantages of both the existing and the potential new benefits in a Suitability Report. If the member does not agree, the transfer does not take place and the member retains his deferred benefits in his old scheme.

If the member decides to proceed with the transfer, he will be required to complete a discharge form, which will also include an authority for the receiving scheme to instruct the previous pension arrangement to transfer the member's benefit to the new scheme. The receiving scheme will have to sign to confirm they are a registered pension arrangement with HMRC and provide payment instructions. The receiving scheme may also have to provide a letter to HMRC allowing the transferring scheme to check the receiving scheme's registered status. This is increasingly common, partly because of releases from HMRC and TPR, advising trustees/managers to satisfy themselves that an improper transfer (i.e. a fraudulent transfer) is not taking place (see Pension Scams section 1.1.5 below).

In general, once the adviser's work is done and the transfer advice accepted, the receiving Scheme Administrator (usually the insurers for a DC scheme or the trustees' representatives for a DB scheme) deals directly with the ceding arrangement in order to facilitate transfers effectively and efficiently on the member's behalf. The receiving arrangement will obtain explicit authority from the member in order to do so, and correspond directly with the ceding scheme. Payment of the transfer value must be made direct from the ceding scheme/insurer to the receiving scheme/insurer. It is important to note that neither adviser nor member is permitted to receive or handle the transfer value monies.

Full details of the transfer will need to be entered on the member's record, and the transfer value should be split between employee and employer contributions, GMP elements, etc., as appropriate. This will also help if the member subsequently leaves the receiving scheme and decides, at a later date, to transfer out all of his or her benefits (including the existing transferred in benefit) to another registered pension arrangement.

1.1.4 Transfers out

Members who leave a pension scheme usually have the right to transfer the value of their benefits to another pension arrangement. The amount transferred is called the 'Cash Equivalent Transfer Value' (CETV) of the member's benefits. Also, members have the right to request a transfer out quotation at any stage, and are entitled to at least one quotation free of charge in any 12 month period provided they are more than 12 months away from normal pension age.

The right to transfer their benefits to another suitable pension arrangement depends on the type of benefits the member has in the transferring scheme as different rules apply.

Members with Defined Benefits

Members with defined benefits (also known as safeguarded rights in this context) who leave pensionable service at least one year before their NRD with a deferred benefit in the scheme have a statutory right to transfer the CETV of their deferred benefits to another suitable pension arrangement.

There is no statutory right to transfer rights earned under an occupational pension scheme before 6 April 1988, if the member leaves pensionable service without leaving employment.

The scheme rules may allow members to transfer their benefits even where they do not have a statutory right to do so.

Where a member wishes to transfer their DB pension to a pension arrangement that provides flexible benefits (i.e. a DC arrangement, such as a personal pension plan) and the transfer value (before any reduction to reflect the funding position of the scheme) is £30,000 or more, the member will have to have obtained appropriate independent advice regarding the proposed transfer.

Before making a transfer payment, the Trustees (or more likely the administrators, on their behalf) must check that the member has received that advice.

Members with public sector DB pensions cannot transfer their pension benefits to another pension arrangement providing flexible benefits.

Members with Defined Contribution Benefits or Other Flexible Benefits (i.e. a Cash Balance Pension)

Members with DC or other flexible benefits also have a statutory right to transfer their benefits to another suitable pension arrangement. The right to transfer applies right up to the point the benefits are taken.

Members with More Than One Benefit Type

If a member has more than one benefit type in a scheme, such as a final salary pension plus DC AVCs, they have a separate right to transfer the benefits from the different categories.

For example a member could transfer their final salary pension and leave the DC benefits in the scheme, or could transfer their cash balance benefits and leave their final salary and DC benefits in the scheme.

The Introduction to this Chapter discussed the historical problems which have arisen with regard to Pension Transfers. The adviser needs to be particularly mindful of this background and the ongoing concern which the Pension Regulator has in this area. In August 2008, to help in the calculation of transfer values, TPR published a *Guidance on calculation of cash equivalent transfer values*. A consultation document was published in August 2008 by the Pensions Regulator (followed by a consultation report in November 2008), making it clear that trustees take responsibility for the transfer value process.

Current rules on DB transfers are covered by FCA in COBS 19 where the default position is that a transfer from a DB scheme will not be suitable unless it can be clearly shown that a transfer is in the member's interest. In June 2017 the FCA also published CP17/16 which proposes a prescribed format bar chart comparison between the CETV and the fund required to buy an annuity. This is then accompanied by a cash-flow projection to illustrate how the benefits from the DB scheme and the possible alternative approach might work. Wider client circumstances and objectives also need to be carefully considered.

For a DC scheme, the transfer value must be paid within six months of the final notification to transfer out being received.

Where a member exercises their statutory right to a transfer, the trustees of the transferring scheme have a full statutory discharge, so that they are not required to provide the member with any benefits to which the cash equivalent related, providing the receiving scheme/arrangement satisfies prescribed requirements. The exact requirements vary depending on whether the receiving scheme/arrangement is an occupational scheme, a personal pension or a buy-out policy.

A member with a statutory right to a transfer can split the cash equivalent between as many occupational pension schemes, buy-out policies and personal pension arrangements as they wish although, generally, for the statutory discharge to apply, all of the value must be transferred.

If trustees allow a member to transfer their benefits where a statutory right does not exist, the trustees do not have a statutory discharge of their liability to provide benefits for the member. In these cases trustees will usually insist that the member completes a form to acknowledge that the trustees will no longer be obliged to provide benefits for them.

The ceding scheme should also consider the receiving scheme's registered status and ask for evidence if appropriate. This is increasingly common, partly because of releases from HMRC and TPR, advising trustees/managers to satisfy themselves that an improper transfer (i.e. a fraudulent transfer) is not taking place (see Pension Scams section 1.1.5 below).

1.1.5 Pension Scams

During the spring of 2013, TPR commenced a campaign to fight the rise of Pension Liberation Fraud and it has continued to publicise this Scorpion campaign under the strapline "Pension Scams. Don't get stung!" Pension Liberation fraud takes a number of different forms, but usually involves a member colluding with a third party to transfer pension rights to an arrangement with a view to accessing benefits before age 55 and in the form of a cash payment, possibly as a loan (which in itself would almost invariably be regarded as an Unauthorised Payment). Clients pay a 'facilitation fee' to the third party, which can be as high as 20% or 30% of the transfer concerned.

The numbers affected by scams, particularly since pensions freedom improved the availability of lump sums, is significant. While we may never know the numbers involved – victims may not wish to admit to being duped and it may be some time before victims realise that their pension savings have gone – the Aviva Real Retirement Report has estimated that since 2010 over one million people have fallen victim to this type of fraud. In August 2017, the Government issued their *Pension Scams: consultation response* confirming that they would be introducing legislation to ban cold calling including texts and e-mails, with the ICO given powers to fine offenders up to £500,000. In November 2017, a Treasury minister told a DWP Work and Pensions Committee that a ban on pensions cold-calling would be in place by 2020. The details of the ban will be set out during 2018: it will prohibit phone calls, text messages and e-mails regarding pensions from firms with which an individual does not have a prior connection. Notably this proposed ban received significant publicity following a petition launched by an IFA just 12 months earlier.

However, no amount of UK legislation will stop scammers calling from abroad: clients and their advisers need to remain vigilant.

Members who abuse tax concessions in this way are subject to heavy tax charges, as the transfer constitutes an Unauthorised Payment: HMRC has issued “protective assessments” in many cases to retain their right to claim these tax charges. The ceding scheme will also be subject to a Scheme Sanction Charge. Both should therefore take extra care. So too should the adviser because he could well be liable to the member for any loss arising as a result of his advice or even facilitation: better not to get involved at all even on an insistent client basis if Pension Liberation is suspected.

HMRC are also seeking to tighten their powers during 2018 by refusing to register new schemes or to de-register existing schemes where the sponsoring company is dormant and where master trusts are involved if they are not registered with TPR. This intention was announced in a Policy Paper issued in September 2017.

Further information and examples of fraud may be found on TPR's website under Pension Scams.

Typical Signs of Pension Fraud

Advisers should be able to identify some of the following signs typically associated with Pension Scams:

- the member may receive an unsolicited call or text message, see a magazine advertisement or may respond to an online advertisement
- there may not be an obvious relationship between the ‘pension scheme’ concerned and its supposed sponsor
- fraudsters may claim to have spotted a legal loophole
- the member may be appointed as a director of the company sponsoring the new scheme being proposed
- the proposal may involve onward investment in a single asset: IFAs will almost invariably seek to diversify and only where they have assessed client Attitude to Risk and Capacity for Loss issues might a single asset be chosen
- the process may involve transferring funds abroad arguably to a more benign tax regime – but that becomes largely irrelevant if the transfer out of the UK gives rise to an unauthorised payment charge
- the process may involve transfer to a seemingly bona fide occupational scheme which in reality has been set up specifically for the purpose of the scam
- fraudsters may claim that their proposals are entirely valid but they just do not happen to be authorised to advise in the UK – though they may be authorised by a foreign regime for other specified business
- they may be reluctant to provide clear written details because “they have spent a lot of money developing their product and do not want that intellectual property to fall into the hands of competitors – that’s fair isn’t it?”. No, it is not! It breaches specific and general FCA requirements to provide clear information for the client in a durable medium before during and after the advice contract is agreed – and it leaves the adviser in an impossible position if he requires evidence to back up any recommendation

- fraudsters will place pressure on members to complete paperwork, and may commonly send motorcycle couriers to collect signed documents
- under-55s may be targeted; remember that IFAs will be aware of the minimum pension age of 55 and only if there are overriding reasons for earlier encashment will funds be legally available. Such a reason might be serious ill-health but that will only be apparent after careful fact-finding
- fraudsters may also pressurise scheme administrators to ensure that transfers are processed quickly. They may even threaten to report schemes to TPR if transfers are not processed.

It is also straightforward to check on a firm's or an adviser's background by looking at the Financial Services Register on the FCA website. If they are not listed then that in itself is a warning. Further, a check can be made to establish if the scheme to which the transfer is to be made is registered in the UK or if it is a QROPS (though listing on the QROPS register is not a guarantee that the arrangement meets HMRC requirements). QROPS are discussed in more detail in section 1.4 below. The FCA itself is closely monitoring potential scams and inter alia encourages whistleblowing. This activity was supplemented with its Scam Smart campaign launched in October 2014 aimed at protecting members of the public and part of this involves an interactive tool, the Scam Smart Warning List which can be accessed by anyone concerned.

Although individuals have a statutory right arising from the Pension Schemes Act 1993 to transfer pension benefits, all professionals within the industry should seek to prevent fraud and to co-operate with TPR, FCA and law enforcement agencies to prevent it.

As more pension scams are uncovered, a sub-industry is growing with the promise of helping to reclaim monies for persons affected by scams. While most participants in this new industry are attempting to provide this niche assistance in clients' interests while making profit for themselves, some caution may be necessary to protect persons already financially hurt from disappointment, concern and even the "double-whammy" of further loss. Advisers should be aware of this possible threat to their clients and also know that the Claims Management Regulator was set up to protect and promote the interests of consumers and the public in such situations. The Claims Management Regulator is a unit of the Ministry of Justice and regulates Claims Management Companies which offer a service for people hoping to claim compensation for, inter alia, mis-sold financial products and services.

1.1.6 Public Sector Transfer Club

The Club consists of a number of final salary occupational pension schemes that have agreed reciprocal transfer arrangements. Final salary schemes provide pension benefits based on reckonable service and pensionable earnings at or near the date the member leaves the scheme.

The Club offers those who move between Club schemes the opportunity to transfer pension benefits on special terms. In general, when members transfer their pension benefits between Club schemes, they will receive a broadly equivalent service credit in the new scheme, regardless of any increase in salary on moving.

Advisers will need to pay special regard to the likely value of a Transfer Club transfer value and it is unlikely that advice would be given to a client not to use the Club availability.

1.2 FCA RULES

The FCA Handbook sets out the requirements: COBS 19.1.2R and 19.1.3G state: “A firm must:

1. compare the benefits likely (on reasonable assumptions) to be paid under a defined benefits pension scheme or other scheme with safeguarded benefits (safeguarded benefits were introduced from April 2015 meaning “benefits which include some form of guarantee or promise during the accumulation phase about the rate of secure pension income that the member (or their survivors) will receive, or will have an option to receive” with the benefits afforded by a personal pension scheme or stakeholder pension scheme, before it advises a retail client to transfer out of a defined benefits pension scheme or other scheme with safeguarded benefits;
2. ensure that the comparison includes enough information for the client to be able to make an informed decision;
3. give the client a copy of the comparison, drawing the client’s attention to the factors that do and do not support the firm’s advice, no later than when the key features document is provided; and
4. take reasonable steps to ensure that the client understands the firm’s comparison and its advice.

In particular, the comparison should:

1. take into account all of the retail client’s relevant circumstances;
2. have regard to the benefits and options available under the ceding scheme and the effect of replacing them with the benefits and options under the proposed scheme;
3. explain the assumptions on which it is based and the rates of return that would have to be achieved to replicate the benefits being given up;
4. be illustrated on rates of return which take into account the likely expected return of the assets in which the retail client’s funds are invested.
5. where an immediate crystallisation of benefits is sought by the retail client prior to the ceding scheme’s normal retirement age, compare the benefits available from crystallisation at normal retirement age under that scheme”

COBS also says that when advising a member of a DB occupational pension scheme whether to transfer, the starting point should be ‘that a transfer will not be suitable’, i.e. the default position is to stay put.

The regulator continues to pay close attention to transfers particularly following Pensions Freedom. CP17/16, *Advising on Pension Transfers*, published June 2017 will lead to new requirements, probably during 2018. We consider this further in the Transfer Value Analysis section below.

COBS requires that individuals advising on pension transfers require a specific pensions transfer specialist permission. This permission is granted on the applicant’s successful completion of a recognised qualification, such as the Diploma in Regulated Retirement Advice.

1.2.1 Record Keeping

Advisers must demonstrate that they have thorough processes in place in order to ensure that advice given to clients is properly researched. This means that there must be a clear record of all information obtained for purposes of the fact find and evidence of the research conducted leading to advice. There must be clear evidence of how the client’s attitude to risk and capacity for loss have been assessed. Firms will be expected to show that they have systems in place to deliver consistent advice to all clients. The FCA Handbook SYSC 9.1 sets out regulatory requirements for record keeping: this is not limited to records with regard to pensions transfers but given the past issues surrounding transfers and the ongoing importance of this matter, it is well worth repeating this requirement at this juncture.

1.2.2 Recommendations

In recommending a particular transfer solution, advisers should provide clear reasons for so doing. In this, lessons can be learned from the pensions mis-selling review of the early 1990s: this was covered in the Introduction to this Chapter. One of the conclusions reached by the regulator at that time was that insufficient evidence was retained for advising that a transfer be made. Many compliance officers at that time concluded that while the advice given to transfer was sound, the files lacked sufficient evidence for the transfer and in consequence compensation needed to be offered and agreed with member. Today, lack of satisfactory evidence would mean that advice given would be regarded as “Unsatisfactory”, “failed Compliance”. It is imperative therefore that the student, on successful completion of the DRRA and in the position of advising members, provides comprehensive reports, suitably evidenced.

Advisers should explain how the advice relates to the client’s objectives, attitude to risk and capacity for loss. The advantages and disadvantages, including a clear analysis of the pre-existing arrangements should be clearly explained. The charging structure for any new products should be explained in full and why the selection represents value for money. The recommendation must provide a comprehensive explanation for why the proposed solution is suitable for the client’s requirements. Alternatives considered and rejected, and why, should be outlined. It is worth looking back at the suitability letter section covered in Part 2 of this study manual as a reminder of wider aspects which need to be covered.

1.2.3 Insistent Customers

Occasionally, clients may wish to reject an adviser’s recommendation and proceed with a particular investment. In the specific case of pension transfers, this may involve choosing to ignore advice to remain in, say, a DB scheme and to proceed with a transfer out. Clients may have a variety of reasons for doing this. Sometimes there will be an emotional motive; the client may, for example, wish to break all connection with a previous employer. Immediate cash in hand – and in this context we are not looking at Pensions Freedom but at a “bribe” being an additional payment for making the transfer out – may also be tempting: in past enhanced transfer value exercises (see 1.6 below), scheme members have been persuaded to transfer out by the lure of a cash payment and are determined to proceed in spite of advice to the contrary (the DWP Working Party – see 1.6.3 below – was aware of cases where up to 70% of those offered cash to transfer were in this position). In such cases, it is vitally important that the adviser writes to the client to advise him or her that in rejecting advice they must be treated as insistent customers, that the adviser is not making any personal recommendation: the adviser should obtain the client’s signed acknowledgement of these circumstances and retain the records indefinitely. Or, if the adviser still has concerns, refuse to deal with that particular piece of business: if that was a refusal to take part in a Pension Liberation exercise, then after some months have passed, the client may be extremely grateful. Pensions Freedom is also likely to give rise to Insistent Client transfers- out and if an adviser becomes involved here, particular care will be needed.

The FCA is aware of the issues and CP17/16 commented as follows:

“Insistent clients. Our Handbook does not currently define an insistent client or contain any provision specific to processing a transaction for an insistent client. We use this term to describe an individual who has received a personal recommendation and chooses to do something different than what was recommended with the help of the adviser who gave the personal recommendation. We published a fact sheet on insistent clients in 2015 [<https://www.fca.org.uk/firms/pension-reforms-insistent-clients>] to assist firms in understanding our position. This factsheet used the example of pension transfers as this is an area where insistent clients are particularly relevant. The content of this factsheet continues to apply.

“It is for an adviser to decide whether they will process a transaction that goes against a recommendation they have given. Where a client has received a personal recommendation not to proceed with a conversion or transfer of safeguarded benefits our rules do not prevent them from proceeding if they want. However, it is essential that the implications are fully explained so that the client is able to understand the decision they are making. It is important to make sure the original personal recommendation is suitable and that the reasons for the recommendation are clear.

“While our fact sheet continues to apply, we recognise that adding guidance to our Handbook will provide greater certainty for firms. We also recognise that the issue of insistent clients applies to a number of areas of advice and not simply in respect of the transfer and conversion of safeguarded benefits. We will therefore consult to introduce Handbook guidance based on the core elements of the factsheet in the coming months.”

1.2.4 Transfer Value Analysis

An important part of the transfer advice process is the financial analysis of the transfer value. This compares a projection of the client's deferred pension with the annuity which could be provided from a personal pension were a transfer to take place. Prior to 2017, the Transfer Value Analysis Service (TVAS) process calculated the investment return that the personal pension would need to achieve in order to match the benefits provided by the deferred pension in its current format: this return is called the Critical Yield.

However the FCA's Advising on pension transfers – our expectations published on 24 January 2017, commented that their “supervisory work has revealed that some firms have been recommending pension transfers based solely on whether or not the critical yield is below a certain rate set by the firm for assessing transfers generally. This does not meet our expectations. The critical yield is the rate of return that would have to be achieved in the defined contribution (DC) pension scheme to replicate the benefits of the DB benefit scheme.” They continued: “We would expect the firm to consider the likely expected returns of the assets in which the client's funds will be invested relative to the critical yield. The firm should also consider the personal circumstances of the client before making any personal recommendation, taking into account specific other factors as they apply to the client”

In another word: “Suitability”!

The FCA's CP17/16 published in June 2017 is developing their requirements. A policy Statement is expected in the first part of 2018.

Currently the actuarial assumptions used for a TVAS calculation are set out in COBS 19.1.4. Advisers requiring a TVAS calculation commonly use the services of one of the major life offices or specialist organisations providing this type of service. COBS provides detailed guidance to actuaries (and this guidance is updated from time to time in line with market conditions) for setting up TVAS systems, and provides pre- and post-retirement assumptions. Briefly, these assumptions (and guidelines) include:

- annuity interest rates to be used in TVAS calculations are set and amended from time to time by the FCA in the COBS Rules to which the actuary would need to refer;
- revaluation rates which actuaries need to apply in calculations are 2.0% (for CPI), 2.5% (for RPI) and 4% (for earnings);
- the mortality tables used are those issued by the Institute and Faculty of Actuaries: Continuous Mortality Investigation tables PCMA00 and PCFA00 and again actuaries need to be aware if changes which may be required by the FCA because of improving longevity.

This comparison will still be required but the emphasis of advice in the pension transfers arena is changing. The following extracts from CP17/16 should help to make the FCA's position clear:

Their Consultation Paper begins:

“Why we are consulting

Defined Benefit pensions, and other safeguarded benefits involving guaranteed pension income, provide valuable benefits so most consumers will be best advised to keep them. However, we recognise that the economic and legislative environment has changed significantly, so we want to ensure that financial advice considers the customer's circumstances in full and properly considers the various options now available to them. We want to provide advisers with a framework which better enables them to give the right advice so that consumers make better informed decisions.

The FCA has rules which govern advice given to consumers on the conversion or transfer of safeguarded benefits. Transferring from such a pension, to one without any safeguards, is an important decision for consumers to take and historically has been unlikely to be their best interests. Therefore our rules are designed to ensure that consumers receive appropriate advice when looking to give up valuable pension benefits.

The proposals set out in this consultation aim to reflect the current environment and the increased demand for pension transfer advice. Since the introduction of the pension freedoms in April 2015, consumers have more options available to access their pension savings. This has combined with more recent changes to the financial environment leading to historically high levels of transfer values.”

Note from the above extract that the FCA is primarily concerned about income such as DB which will be given up. They are less concerned about pension switches between money purchase schemes though such switches would need to meet wider suitability requirements. This is reiterated, along with other goals, in their stated intentions which are to

- update and add to Handbook guidance on assessing suitability when giving a personal recommendation to convert or transfer safeguarded benefits
- introduce Handbook guidance on the role of a pension transfer specialist, and amend the definition of a pension transfer specialist
- replace the current transfer value analysis requirement (TVA) with a requirement to undertake an appropriate pension transfer analysis (APTA) of the client's options including a prescribed comparator indicating the value of the benefits being given up, and
- restrict the application of the additional requirements in respect of pension opt-outs to those cases where there are potential safeguarded benefits

The APTA will include, as a minimum:

- an assessment of the client's outgoings and therefore potential income needs throughout retirement
- the role of the ceding and receiving scheme in meeting those income needs, in addition to any other means available to the client – effectively obtaining an understanding of the client's potential cashflows
- consideration of death benefits on a fair basis, for example where the death benefit in the receiving scheme will take the form of a lump sum, then the death benefits in the ceding scheme should also be assessed on a capitalised basis, and both should take account of expected differences over time
- the prescribed comparator.

Commenting on the role of the pensions transfer specialist, they say:

“The transfer of safeguarded benefits is an increasingly complex area and ... we aim to provide clarity on the role of the pension transfer specialist and our expectations of those performing this role. Those providing Pension Transfer Specialist qualifications will want to consider these proposals. We will update the appropriate exam standards in relation to pension transfer specialists in due course.

“Advice on pension transfers, pension conversions and pension opt-outs must be given or checked by a pension transfer specialist, who must be a fit and proper person with specific qualifications. The existing requirements do not specify what is intended when a pension transfer specialist checks, rather than gives, advice on the transfer or conversion of safeguarded benefits. We have seen cases where a pension transfer specialist simply runs the Transfer Value Analysis (TVA) calculation or checks the numbers that have been produced rather than looking at the overall assessment and recommendation made as a whole. This is not in line with our expectations.

“We propose to add guidance to our Handbook to make clear that checking the advice means assessing the reasonableness of the personal recommendation reached by the adviser. Checking does not require a fundamental repeat of the advice process, but will involve an independent assessment of the soundness of the basis for the advice. It should take into account the client's wider circumstances, including their appetite and capacity for risk and the nature of the scheme being transferred to. In cases where the pension transfer specialist considers that the outcome reached by the adviser is unreasonable, or does not consider that all the relevant factors have been included; we expect the pension transfer specialist to clearly document the reasons for their view and for the adviser to take this into account in their recommendation to the client and the communications that accompany this advice.

“We propose to amend the glossary definition of a pension transfer specialist to support this. It currently defines a pension transfer specialist as someone who checks the suitability of the transfer. We do not consider this accurately represents the requirements on a pension transfer specialist or the responsibility of the main adviser for the overall suitability of the advice. We propose to change this definition to refer to checking the reasonableness the outcome of the advice.

“A pension transfer specialist must hold a specific qualification set out in our training and competency requirements. In many cases advisers hold the pension transfer specialist qualification in addition to the Level 4 Retail Distribution Review (RDR) advice qualifications but there is no requirement for a pension transfer specialist to be an investment adviser.

“Advice on a conversion or transfer of safeguarded benefits will often also be investment advice. Where the adviser holds both the investment advisor and pension transfer specialist qualifications they can give the advice without any further checking. Where the adviser is not a pension transfer specialist they need to have that advice checked. We have stated that the destination of the funds transferred, including how they are invested is a key element in assessing the suitability of a conversion or transfer of safeguarded benefits. However, a pension transfer specialist checking this advice does not need to be an investment adviser.

“Firms must make sure that their employees are competent to undertake the roles they are performing. Given the complexities of this area it is our view that the pension transfer specialist qualification alone is not enough to demonstrate this competence. Relevant experience is essential, as is maintaining knowledge. For example, we expect firms to make sure that pension transfer specialists have experience on a suitable range of cases – for example, on a supervised basis – and that their experience remains current. It may be challenging for advisers who are not regularly involved in advising on the conversion and transfer of safeguarded benefits to evidence an appropriate level of competence.

“Responsibility for advice – outsourcing pension transfer specialist checking. We are aware that in a number of cases, the pension transfer specialist checking role will be outsourced. The outsourcing might be to a pension transfer specialist at another adviser firm in the same network; to a separate adviser in the local area; or to a stand-alone pension transfer specialist.

Where outsourcing of this function has taken place, we believe our current rules, together with the proposed additional guidance on checking, provide an appropriate framework. The adviser giving the overall advice remains responsible for the suitability of the advice, including the advice checked by the pension transfer specialist. Although a pension transfer specialist who is checking advice may not have a liability to the client, for example because they do not have a contract with the client, there might be a liability to the referring adviser if the pension transfer specialist were to fail in properly checking the advice.

“Responsibility for advice – outsourcing pension transfer advice. In some cases the pension transfer advice and liability is outsourced in its entirety to another firm. They take on all aspects of the personal recommendation including levying the charges associated with the personal recommendation. The original firm plays no role in the advice being given.

“Alternatively, firms without the relevant permission to advise on the transfer or conversion of safeguarded benefits might have clients who are seeking this advice. They can pass the transfer element of advice to an adviser with the appropriate permission but retain a role in advising on the destination of the funds following the transfer, e.g. the specific personal pension scheme and the investments within it. In practice, the assessment of suitability on the transfer cannot be done without consideration of the destination for the transferred funds and vice versa. Therefore in this scenario, although the firms are responsible for different elements of advice given to the client, they will need to liaise to ensure the overall recommendations are suitable and to avoid any disconnect. Both firms must be able to demonstrate the advice they give is suitable for the client.”

The above extracts may be lengthy and they may be adjusted before the new requirements are embedded in COBS. But they are important and central to the role of students studying for the DRR.

The importance for advisers keeping within the latest FCA parameters cannot be overemphasised. Strong echoes from the 1990s pensions mis-selling scandal still reverberate around the industry and when the potential for fraud through pensions scams considered elsewhere in this manual is taken into account, advice has to be delivered, seen to be delivered and proved to have been delivered absolutely correctly. As the FCA say in CP17/16: “A successful outcome will be measured by a reduction in the number of complaints against advisory firms, fewer interventions by the FCA in this area, fewer customers becoming the victims of pension scams and greater certainty and confidence amongst advisers as to the expectations for this type of advice ”

1.3 HMRC REQUIREMENTS

There is significant freedom as far as transfers are concerned and there will always be some organisations happy to accept pensions transfer monies. But anyone transferring, as well as ensuring other aspects of the transfer are in his interests, needs to be mindful of possible HMRC penalties. We discussed Pension Scams earlier in this Chapter. But even when advisers and members are avoiding scams, care still needs to be exercised with regard to the transfer. We will now consider in the following paragraphs transfers generally with particular reference to HMRC matters.

A transfer from a registered pension scheme to another registered pension scheme is a recognised transfer under the Finance Act 2004. No tax charges or sanctions apply to recognised transfers. A recognised transfer from one registered pension scheme to another is not a benefit crystallisation event (BCE). BCEs are considered in Taxation, Retail Investment and Pensions.

A recognised transfer from one registered pension scheme to another is not a contribution, so no tax relief is due in respect of the transfer and the transfer does not count towards the maximum tax-relievable contributions for the year in which the transfer is made. The contributions to the transferring scheme would usually have received tax relief when originally made to that scheme and the transfer is merely relocating the pension rights represented by those contributions to a different registered pension scheme.

A transfer from a registered pension scheme to a non-registered scheme is not a recognised transfer. It is an unauthorised payment and will lead to tax charges against the member and the trustees of the transferring scheme. Members do not have a statutory right to a transfer which is not a recognised transfer, so any such transfers would only be paid at the discretion of the trustees and in accordance with the provisions of the scheme rules.

Loss of Enhanced Protection

When a member transfers benefits they will lose their right to Enhanced Protection and other Fixed Protections (see Part 1 of Taxation, Retail Investment and Pensions) unless the transfer is a permitted transfer. Heavy tax charges could apply if a transfer which is not a permitted transfer is made. Because of the importance of Enhanced Protection to a member, the adviser should check whether or not the member holds a Certificate of Enhanced Protection or one of the later forms of Fixed Protection. In the unlikely event that the transfer is made in these circumstances then HMRC should be informed. This will avoid a £3,000 fine which HMRC could otherwise impose as a result of the unauthorised transfer.

HMRC identify both permitted transfers and transfers which are not permitted transfers - impermissible transfers. A transfer is a 'permitted transfer' if:

- pension rights under an arrangement are transferred to form all or part of the assets of one or more other money purchase arrangements under a registered pension scheme or recognised overseas pension scheme;
- pension rights under a defined benefits or cash balance arrangement are transferred to form all or part of the assets of a defined benefits or cash balance arrangement under a registered pension scheme or recognised overseas pension scheme, subject to the proviso that the transfer is made in connection with the winding up of the original pension scheme containing the cash balance or defined benefits arrangement, and the receiving cash balance or defined benefits arrangement relates to the same employment as the transferring arrangement that is being wound up (there are two other minor provisos, but the student does not need to know about these);
- sums and assets being used for the provision of a scheme pension (crystallised benefits) are transferred to an insurance company as a result of the winding up of the transferring pension scheme.

Where a permitted transfer is made Enhanced and Fixed Protections will not be lost and all of the constraints relating to enhanced protection apply equally to the arrangement to which the transfer is made.

The following are examples from the PTM of transfers that trigger loss of Enhanced and other Fixed Protections if a transfer is made:

- to a scheme that is not a registered pension scheme or a recognised overseas pension scheme
- from another money purchase arrangement (i.e. non-cash balance) to either a cash balance arrangement or a defined benefits arrangement
- from a cash balance or defined benefits arrangement to another cash balance or defined benefits arrangement where the transfer is not made because:
 1. the transferring scheme is winding up (see previous section), or
 2. the transfer is not made as part of a retirement-benefit activities compliance exercise or a relevant business transfer (see PTM092400). In other words, their employer has sold all or part of their business and the member's benefits are being transferred to their new employer's scheme.

The following are examples of impermissible transfers triggering loss of fixed protections:

- a transfer of sums or assets from an arrangement under a registered pension scheme not relating to the individual. However, a transfer pursuant to a pension sharing order is not an impermissible transfer and will not cause the loss of enhanced protection.
- a transfer of sums or assets which were held otherwise than by a pension scheme.
- the payment of a transfer lump sum death benefit into the arrangement (a transfer lump sum death benefit can only be paid in respect of a member who died before 6 April 2007).

Loss of Protected Retirement Age

When a member transfers benefits they will lose their right to a protected pension age of below age 55 unless the transfer is part of a Block Transfer.

Loss of Protected tax-free cash

When a member transfers benefits they will lose their right to “grandfathered” Pension Commencement Lump Sum (i.e. a tax-free lump sum of more than 25% of the value of the member’s benefits) unless the transfer is part of a Block Transfer.

Block Transfers

A block transfer is an easement permitted by HMRC. It applies to pension rights accrued before 6 April 2006 where the member’s entitlement to a Pension Commencement Lump Sum exceeded the 25% maximum of accrued rights normally permitted or where there is a Protected Retirement Age. If a Block Transfer applies these rights may be preserved.

A summary of HMRC’s definition of a Block Transfer (from the Pensions Tax Manual) follows: “A ‘Block Transfer’ means a transfer involving a group of members (i.e. at least two members) from one registered pension schemes to another, such as due to an employer rearranging its pension schemes or as part of a business transaction”.

The transfer must be in a single transaction and represent all of the sums and assets held for the purposes of (or representing accrued rights under) the arrangements under the pension scheme from which the transfer is made, which relate to the group of members in question of that pension scheme. To be a single transaction:

- all of the sums and assets must be transferred from the transferring scheme to only one receiving scheme. Two or more partial transfers to two or more different schemes cannot be a transfer in a single transaction; and
- the transaction must be made under a single agreement for a single transfer between the two schemes.

It is not necessary that all of the sums and assets are all physically passed from the transferring scheme to the receiving scheme on the same day – there may be legal or administration reasons why this is not possible. However they should all be transferred in relation to the agreement to transfer and within a reasonable timescale.

1.4 OVERSEAS TRANSFERS

An overseas pension transfer is broadly similar to a transfer to another UK registered pension scheme with the additional requirements that the overseas arrangement should be a Qualifying Recognised Overseas Pension Scheme (QROPS) and that a Lifetime Allowance test takes place.

For an overseas pension scheme to be a QROPS, the QROPS scheme manager must have met all of the following conditions* (see Note)

- they have notified HMRC that it is an overseas pension scheme and, if required, have provided supporting documentation. If documentation is required HMRC would normally ask for a copy of the letter of tax approval or a letter from the tax authority confirming that status. But if the country in which the scheme is established does not have a system of tax approval then a letter from the tax authority confirming that the scheme is resident there and a copy of the scheme's rules may be required instead.
- they have undertaken to notify HMRC if it ceases to be an overseas pension scheme
- they have undertaken to provide to HMRC, by 31 January next following the end of the tax year in which a Lifetime Allowance charge occurs, the following information:
 1. the name and address of any member in respect of whom there has been a Lifetime Allowance Charge in the tax year;
 2. the date, amount and nature of that charge.
- the overseas pension scheme has not been excluded from being a QROPS because the Inland Revenue has decided that there has been a failure to comply with any prescribed benefit information requirements imposed on the scheme manager and the failure is significant

** Note: These conditions are set out in The Pension Schemes (Information Requirements – Qualifying Overseas Pension Schemes, Qualifying Recognised Overseas Pension Schemes and Corresponding Relief) Regulations 2006 (SI 2006/208) and by paragraphs 5(1) and 5(3) of Schedule 33 to the Finance Act 2004*

These conditions must apply for at least five years following the transferring member becoming non-UK resident.

The scheme manager for the would-be QROPS should apply to HMRC in Nottingham using form APSS251. In response to this HMRC will send the scheme manager a letter of acceptance that the scheme is a QROPS and the letter will show the unique QROPS reference number for that scheme. The QROPS will be entered on the Pension Schemes Services (PSS) database. HMRC may ask the scheme manager for more evidence before issuing a letter of acceptance (or rejection).

In many cases the acceptance letter will be issued on the basis of the information that the scheme has provided to HMRC on the form APSS251. That information may subsequently be checked by HMRC. If there are errors in that information such that the scheme cannot meet the requirements to be a QROPS, this will be considered to have always been the position regardless of the issue of the acceptance letter. This could have serious consequences for the member, and the member's adviser, if HMRC then impose an unauthorised payments charge.

Where it is proposed to transfer the rights of a member of a registered pension scheme to an overseas pension scheme the transferring scheme, the member or their financial adviser can check if the scheme appears on the list of those QROPS that have consented to their names being published (by tick box on APSS251) on the HMRC internet site.

Because of HMRC confidentiality rules PSS will not be able to answer queries about the QROPS status of an unlisted overseas pension scheme unless it has received from the manager of that scheme written authorisation for it to disclose whether or not the scheme is a QROPS. The letter or form providing authorisation must be signed by the manager of the overseas scheme in order for PSS to answer the query.

But, because the manager of an overseas pension scheme which is a QROPS will have received a letter of acceptance from PSS, another way of checking on an unlisted scheme's status would be to ask the manager for sight of that letter.

Even though an overseas pension scheme is a QROPS, which status has significance for UK tax purposes only, the member/adviser will still need to check that the overseas scheme can accept a UK transfer value.

It is extremely unlikely that schemes will allow a transfer to be paid to an overseas arrangement which is not a QROPS because:

- a member does not have a statutory right to transfer to an overseas pension scheme which is not a QROPS, so any such transfer made would be paid on a discretionary basis and subject to the provisions of the scheme rules
- any such transfer would be an unauthorised payment and would be subject to a tax charge both on the scheme and the member.

The member will need to complete a declaration to enable the administrator to determine the member's available lifetime allowance, because a transfer to a QROPS is a Benefit Crystallisation Event (BCE). Further details on BCEs can be found in Part 1 of the study manual for Taxation, Retail Investment and Pensions.

If the value of the member's benefits exceeds their remaining available LA, a Lifetime Allowance charge of 25% on the excess must be deducted from the transfer value and accounted for in the next quarterly Accounting for Tax return to HMRC. Details of all overseas transfers must be included in the scheme's annual event report to HMRC.

If the member has relied on transitional protection to avoid or reduce an LA tax charge, on a transfer to a QROPS this must also be reported on the event report.

From August 2014, HMRC have published a list of Recognised Overseas Pensions Schemes. (Prior to that the list was headed "Qualifying Recognised Overseas Pensions Schemes"). Since that time, HMRC have emphasised that they cannot guarantee that listed schemes are free of fraudulent activity or that any transfers to them will be free of UK tax. "It is your responsibility to find out if you have to pay tax on any transfer of pension savings" they say! It is because HMRC could not definitively verify the bona fide nature of QROPS that the "Qualifying" prefix was dropped.

A further overseas arrangement with which advisers may meet is a Qualifying Non-UK Pension Scheme (QNUPS). This type of scheme arises out of The Inheritance Tax (Qualifying Non-UK Pension Schemes) Regulations (SI 2010/51). A QNUPS, being unregistered in the UK has no reporting obligations to HMRC. While there is no UK tax relief on contributions, those clients whose pension rights exceed the Lifetime Allowance in value would not have concerns here, and there could be exemptions from tax on income and on capital gains in the fund. Importantly a QNUPS enjoys relief from Inheritance Tax, provided there has been no deliberate attempt to avoid IHT by persons in severe ill-health, and may therefore offer advantages for HNW clients whose pension funds exceed the Lifetime Allowance or who cannot obtain tax relief on contributions (because they have already reached their contribution limit). But like any IHT avoidance vehicle it is open to attack by the Government if they feel legislation is being "over-used". A QNUPS is a highly specialist contract generally for very wealthy clients and from the transfer perspective must be dealt with very carefully and within the knowledge and competency of the adviser and firm involved. A transfer to a QNUPS from a registered pension scheme will be an unauthorised payment.

1.4.1 Transferring Benefits to the UK

The issues involved with transfers of pension benefits into the UK from overseas schemes are broadly similar to transfers from other UK registered pension schemes. If the transfer meets the requirements of the receiving scheme the only difference (within the UK) will be that the individual may be entitled to an enhancement to their Lifetime Allowance in respect of any accrued benefits that have not received UK tax relief. It is the individual's responsibility to investigate whether they are entitled to such an enhancement and in this, as well as in the wider issues involved in making a transfer, advice is desirable.

The adviser, if UK-registered, would also need to ensure he has the relevant MiFID passporting authorisation if advice is given to the member while the member is abroad. (Briefly, the Markets in Financial Instruments Directive represents an EU objective, also considered in Part 1 of this manual, targeted at harmonising financial services legislation across the EU and improving protection for consumers. Brexit may mean requirements here will change.)

1.4.2 Working Overseas

Where an employee moves abroad to work, they will usually join a scheme based in their new home country but, since 6 April 2006, individuals who are not resident in the UK can remain (or become) members of a UK registered pension scheme.

Whilst the individual is abroad, they can continue to make contributions to and continue to accrue benefits within a UK registered pension scheme, but they will not be entitled to UK tax relief on those contributions, except under specific circumstances. A member of a registered pension scheme who is no longer resident in the UK can be treated as a “relevant UK individual” in specified circumstances for a tax year if they were:

- resident in the UK at some time during the five tax years before that year and when they became a member of the pension scheme, and
- not employed by a UK tax resident employer.

The inclusion of UK domiciles working abroad within this relevant UK individual definition is helpful in that a person working abroad (on a long secondment perhaps) for a supranational company can still remain in the UK scheme and his UK employer can still obtain Corporation Tax Relief on contributions made on his behalf. There are potential implications for the overseas employee even if resident outside the UK and paid in Euros, implications of which an adviser should be aware even if the member is not contributing himself. The tax authorities in the EU country where he works may still require assurances that any UK employer contributions made are going to a registered UK pension scheme. A UK company whose Sales Director, say, is in continental Europe developing business there is not going to be happy with the adviser if their key employee gets an unexpected tax bill!

An employee who ceased to be resident in the UK more than five tax years ago will cease to be eligible for UK tax relief (though UK scheme membership may continue).

If no UK tax relief is received whilst the individual is resident outside the UK, they can apply for an enhancement to the Lifetime Allowance which has the effect of ignoring those amounts which did not benefit from UK relief. The individual concerned must fall within the definition of a “relevant overseas individual”. A “relevant overseas individual” is defined by HMRC as an individual who either:

- does not qualify for UK tax relief on contributions paid to a registered pension scheme because they are not a relevant UK individual, or
- qualifies for tax relief on contributions up to the basic amount (£3,600 gross for the 2019/20 tax year) because they are treated as a relevant UK individual under specified circumstances.

1.5 CALCULATING TRANSFER VALUES

1.5.1 Introduction and Legal Background

Where the transferring scheme (ceding scheme) is a money purchase arrangement, the transfer value is normally just the value of the member’s fund (with appropriate adjustments to reflect any penalties or charges resulting from disinvestment).

Where the ceding scheme provides defined benefits, the transfer value will be the amount that the actuary to the scheme calculates to be equivalent in value to those benefits and the following paragraphs consider the calculation of these equivalent values and associated matters.

Under The Occupational Pension Schemes (Transfer Values) Regulations 1996 (SI 1996 No 1847), when a member requests a statement of their Cash Equivalent Transfer Value (CETV), a calculation of their cash equivalent must be made with an effective date no later than three months after the date of the request. The effective date is known as the guarantee date. Where, for reasons beyond their control, the trustees are unable to calculate the transfer value within the three months, the time limit may be extended for up to a further three months.

A written “statement of entitlement” must be issued to the member within ten working days of the guarantee date, which must include a statement of the guaranteed cash equivalent and the guarantee date.

If a member exercises his or her statutory right to a transfer payment (by making a formal written application to the trustees) within three months of the guarantee date, the guaranteed cash equivalent must be paid within six months of the guarantee date.

The time limits quoted above may not apply where the scheme is subject to a freezing order issued by TPR to protect members’ interests in the scheme whilst it is considering issuing an order to wind up the scheme.

From 1 October 2008, the trustees of registered pension schemes became responsible for determining the basis for calculating transfer values and for the assumptions used in DB transfer calculations after taking advice from their actuary. Prior to 1 October 2008, the actuary had been responsible for these aspects.

This change in responsibility affected not only CETVs, but also cash transfer sums for short service leavers, valuations of benefits for divorce purposes and other transfer values for members who do not have a statutory right to transfer their benefits. Similarly, trustees also became responsible for determining how to calculate benefits upon a transfer into the scheme.

These changes were introduced by The Occupational and Personal Pension Schemes (Transfer Values) (Amendment) Regulations 2008 (SI 2008/2450). These Regulations also introduced the concept of an “initial cash equivalent”. This is the minimum cash equivalent calculated using a prescribed approach, before any reductions which might be applied, for example, where scheme is significantly underfunded.

The final “cash equivalent” may be either:

- (a) the initial cash equivalent minus any reductions, or
- (b) an alternative cash equivalent, provided this is higher than (a).

The alternative cash equivalent in (b) allows trustees to pay cash equivalents higher than the minimum that is payable in (a).

The initial cash equivalent must be calculated using an “actuarial basis” and must represent “the amount at the guarantee date which is required to make provision within the scheme for a member’s accrued benefits, options and discretionary benefits”.

Where a scheme is in an assessment period for the Pension Protection Fund, the payment of transfer values is prohibited. This does not, however, prevent the external transfer of a pension credit for a member’s ex-spouse or ex-civil partner.

It is essential that administrators maintain accurate records of the destinations of transfer payments. This prevents discrepancies on retirement when members attempt to trace their benefits but do not recall transfers. Administrators must also ensure they receive the relevant confirmation from the receiving arrangement, certifying that they meet the statutory criteria, to ensure that the trustees receive the statutory discharge.

1.5.2 Calculation Basis of DB Transfer Values

The actuarial value of the benefits which would otherwise be preserved for the member should represent the expected cost to the scheme of providing the benefits (although trustees are able to reduce transfer values if the scheme is underfunded against a transfer value test and they have received an “insufficiency report” from the scheme actuary). The discount rate used must be based on market rates of return on equities and gilts.

Discretionary benefits, such as pension increases, must be taken into account, unless the trustees direct otherwise. In some circumstances, when a scheme is underfunded for example, there may be sound reasons for excluding any allowance for discretionary benefits. The trustees must consult the actuary and obtain a written report from them before excluding such an allowance in the calculation of the cash equivalent.

If the scheme rules include any provisions that allow deferred members to exercise an option which would increase the value of their benefits, the transfer value should be based on the assumption that the member would use that option.

For example, if a scheme has a normal retirement age of 65, but deferred pensioners have a right to retire from age 60 with no reduction to pension, the transfer value calculation must be based on retirement at age 60, as this is the most valuable option for the scheme member.

Allowance may be made for expenses, whether costs or savings. For example, the scheme may save some administration costs in the future if the member takes a transfer, and it may incur costs if there is a need to sell investments to pay the transfer.

DB transfer values should be split into elements relating to pre 6 April 1997 service, 6 April 1997 to 5 April 2005 service and post 5 April 2005 service. If the scheme has adopted deferred revaluation of 2.5% on the post 5 April 2009 benefits, the value of the post 5 April 2009 service would also be shown. If there is a GMP its value should also be separately quoted. This is so that the scheme receiving the transfer payment can apportion the benefits it sets up for the member into these various elements correctly.

If the scheme is underfunded, the trustees may provide reduced CETVs. This is permitted if the Scheme Actuary has produced an Insufficiency Report. When providing reduced transfer values, trustees are required to consider issues such as:

- the extent to which the scheme is underfunded
- the strength of the employer covenant
- the length and structure of the agreed Recovery Plan
- the availability of contingent assets that might be available were an insolvency event to occur
- whether or not the employer is in a position to make compensation payments to the scheme were unreduced transfer payments to be made

1.5.3 Annual Funding Statement

Because assets in a scheme belong to all members in proportion to their benefits, the calculation of transfer values can be linked to scheme valuations. From 1 October 2008, it became the responsibility of the trustees to take the decisions on what the calculation of CETVs should be based. Previously, the calculation had to be certified by the scheme's actuary as consistent with a professional technical standard. Detailed guidance is offered by TPR for trustees as to the minimum transfer value which should be paid but if funds are insufficient that can be reflected in the transfer value calculation.

On 27 April 2012, TPR published its first *Annual Funding Statement: Helping Trustees understand the Regulator's Expectations*. This provided guidance to trustees on carrying out scheme valuations during an era of extended economic austerity. It was aimed at trustees and employers of DB pension schemes undertaking their scheme valuations with effective dates in the period September 2011 to September 2012. It therefore applied to approximately one third of the UK's 6,500 DB schemes, and about 4m of the 12m DB memberships. It is, however, relevant to all trustees and employers with a DB pension scheme.

The objective was to ensure that schemes should continue to meet their obligations to members whilst seeking to reduce long-term deficits. TPR believes that Trustees and employers who follow the guidance in the statement are more likely to reach funding agreements that TPR finds acceptable without the need for regulatory involvement.

1.6 TRANSFER AND WIND-UP INCENTIVES

One of the main ways in which employers have sought to manage DB scheme deficits includes offering members an inducement to transfer out of the scheme or to accept a reduction in benefits. At the same time, because the Transfer Values offered are calculated on a basis which will reduce the scheme's liabilities and thereby the liability of employers, this in turn improves the bottom line in employer's Annual Accounts.

An inducement offer is where an employer offers scheme members a financial sweetener (such as an enhanced transfer value or a cash lump sum) to transfer their benefits out of a DB occupational pension scheme or to accept a reduction in benefits under the scheme (e.g. to give up their right under a scheme's rules to pension increases in excess of the statutory minimum). From the employer's perspective, this has the advantage of reducing the value of the scheme's liabilities and the risks associated with funding those liabilities.

From the member's perspective, cash in hand has obvious attractions and, if the inducement is offered to existing pensioners to give up future pension increases, the prospect of higher immediate pension is more attractive than an increasing pension. In the latter scenario, pensioners in poor health could certainly benefit: e.g. an early retiree suffering from multiple sclerosis but still able to enjoy life in the sun for a few years.

If the member transfers from a DB scheme to a DC scheme or personal pension, the member would bear all of the future investment risk and would not be eligible for any compensation from the Pension Protection Fund in the event of the employer's insolvency. He will, however, have control over the investment of his pension assets and greater choice re the timing of his retirement and the type of pension to secure at retirement. He could also remove the small pre-NRD risk not covered by the PPF in the event of the employer going out of business while the DB scheme is underfunded.

However, concerns have been raised about inducement offers. The main concern is that members may lose out as a result of transferring into a new scheme or giving up their right to certain benefits (notwithstanding the fact that they receive a financial inducement for doing so) and that they may seek to claim compensation from their employer and/or the trustees of their former scheme in the future in respect of any loss that they suffer.

TPR, because of their statutory duty to protect members' benefits, has for some years taken a keen interest in inducement exercises. They are concerned that members may be disadvantaged by inducement exercises since poor choices can have an adverse effect on the amount of a member's pension. This is especially so if the inducement exercise is not conducted in a manner which ensures that it is likely that most of the members will make properly informed choices. TPR first issued detailed guidance with regard to inducement exercises in January 2007, updating this in December 2010.

In response to regulatory concerns regarding inducement exercises, in 2011 the Department of Work and Pensions assembled a working party to draw up a Code of Practice to govern Enhanced Transfer Value (ETV) and Pensions Increase Exchange (PIE) exercises. In June 2012 this working party published their report: *Incentive exercises for pensions: a Code of Practice*. Compliance with the Code remains voluntary, but the then Pensions Minister suggested that if employers and their advisers do not comply with the Code's provisions, formal compulsion will be introduced.

The Code was last updated in January 2016 by the Incentive Exercise Monitoring Board which succeeded the working party. It is also placing Wind-up Lump Sum exercises on its monitoring radar although they were not part of the remit of the original working party.

This Code of Practice seeks to ensure that all incentive exercises enable members to make informed decisions and better choices and be:

- done fairly and transparently;
- communicated in a balanced way and in terms that members can understand;
- available with appropriate regulated and qualified independent financial advice that is paid for by the employer;
- able to achieve high levels of member engagement;
- be provided with regulated access to the independent complaints and compensation process.

TPR welcomed the pension community's approach to improving practice on inducement exercises and has encouraged employers and their advisers to follow the good practice set out in the Industry Code and will have regard to the Industry code, wherever relevant, in the conduct of any regulatory proceedings relating to inducement exercises.

TPR has further commented that because of the alignment of the Industry code to their approach, their December 2010 guidance has been significantly curtailed. However, concerns with regard to inducement exercises remain and the Regulator has issued, in July 2012, their Statement from The Pensions Regulator: Incentive exercises giving their views and setting out their Principles.

They comment on the risks associated with incentive exercises as follows:

- where a member accepts an inducement exercise offer, an employer's pension liability or risk is likely to be reduced;
- for members the risk that they will suffer a loss in the long run will usually increase if they accept an offer. Losses could be due to factors specific to the individual (e.g. greater life expectancy or questionable investment choices) or the overall economic and market environment in future. An inducement exercise offer is often set at below 'cost-neutral' terms in order to reduce an employer's pension liabilities and in this situation there is a heightened risk that members will be worse off.

They say that a minority (and, very possibly, a small minority) of members may have personal circumstances which result in their being in a better position through accepting an inducement exercise offer.

TPR points out that inducement offers can create risks for trustees and employers as well. These include: legal and reputational risks materialising many years after the inducement exercise has taken place; cost, not only the direct cost of paying the incentive itself, but also the cost of advice (legal, financial and actuarial).

TPR observes that the Code does not address trustee responsibilities in detail, but recommends that trustees obtain advice, where necessary. Because trustee responsibilities fall within TPR's remit the Statement says: "Trustees should start from the presumption that inducement exercises are not in most members' interests. Therefore they should approach an inducement exercise cautiously, making sure they understand the extent of their legal obligations (including under legislation, trust law and their scheme's governing documentation). This will involve taking advice, where necessary, and acting in accordance with these obligations. To discharge these obligations, trustees will need to ensure they fully understand the inducement exercise and its structure as well as how it achieves the level of good practice recommended in the Industry Code. Trustees need to pay attention to the requirement for them to act fairly in relation to the members, including between any members transferring out and those remaining in the scheme, and to the impact on their scheme's funding position."

TPR (in their guidance on incentive exercises issued in July 2012) advises that trustees should:

- Engage – not only should an employer consult with the trustees when considering an inducement exercise, the trustees should actively engage with the proposal from the start to so that members are properly informed and treated fairly. Sound internal controls should inform trustees of potential inducement exercises through increased data requests from third-party advisers.
- Manage conflicts (TPR offers more information in their conflicts guidance).
- Be aware of and meet their data protection duties.
- Consider the funding impact – and potential implications for the strength of the employer's covenant to the scheme (and its ability to fund the scheme) where its capital is used for an inducement exercise.

Trustees, TPR comments, are not expected to make the members' decisions for them, and they should be careful not to advise members where they are not authorised to do so.

Where trustees are unable to resolve concerns with the employer in relation to an inducement exercise, they can refer the issue to TPR or Pensions Ombudsman.

TPR will investigate reports of cases where behaviours give them cause for concern. Examples of issues of concern include:

- Selective offers to certain scheme members which are seeking to advantage one section of membership over another.
- Any attempt to exploit the protection of the PPF.
- Funding exercises in a way that could have an adverse effect on the employer's ability to fund the scheme deficit (and any future deficit) in accordance with the existing recovery plan.
- Coercing or placing undue pressure on members to transfer or give up their benefits.

Where an inducement exercise warrants review by TPR, that review would consider the trustees' involvement in the exercise. Where TPR has concerns as to the ability of the trustees to act in accordance with their trustee duties and to demonstrate sufficient knowledge and understanding, this may result in a much wider review of the general administration and governance of the scheme. Where significant concerns exist in this area, TPR has powers to intervene (such as the removal of trustees or the appointment of an independent trustee).

TPR outlines their Principles for incentive exercises being the minimum standards by which inducement exercises would be conducted:

Principle 1: Clear, fair and not misleading

An offer should be made in a clear, fair and not misleading way, to enable members to understand the implications and make decisions that are right for them.

Principle 2: Open and transparent

The offer should be open and transparent, so that all parties involved in the process are made aware of the reasons for the exercise and the interests of the other parties.

Principle 3: Manage conflicts of interest

Conflicts of interest should be identified and appropriately managed in a transparent manner and, where necessary, removed.

Principle 4: Trustee consultation

Trustees should be consulted and engaged from the start of the process, with any concerns arising through the exercise alleviated before progressing.

Principle 5: Independent financial advice

Fully independent and impartial financial advice should be made accessible to all members and promoted in the strongest possible terms. In almost all circumstances, the structure of the offer should require that members take financial advice. In some circumstances (such as some Pensions Increase Exercises) financial advice may not be required; however, the structure of the offer should provide detailed guidance instead.

If conflicts are appropriately managed, if trustees are engaged throughout the exercises and if the Principles in the Industry Code are followed, then TPR believes the inducement exercises will fulfil and be consistent with their Principles. They intend to review the information that is produced by the Industry Code's monitoring body on adherence and standards under its code and keep their own position under review.

1.7 ADVANTAGES AND DISADVANTAGES OF PENSION TRANSFERS

The advantages and disadvantages of making a transfer, or accepting an inducement offer, will differ depending on whether you are the person looking to transfer benefits or the pension arrangement making the transfer.

The employer sponsoring a DB pension schemes may want to encourage members to transfer out of the scheme so that it can reduce the ongoing cost of the scheme or remove future variable costs. This encouragement may be given by offering members enhanced transfer values.

But if you look at this enhanced transfer value offer from the member's point of view, it is necessary to offset any enhancement to the transfer value against the loss of a defined benefit when the member decides to take that benefit. This is where the transfer analysis, Suitability Report and adviser's input are particularly valuable. The transfer value is likely to be paid into a DC arrangement where the individual will be taking all the investment risks. Or it may be taken wholly as cash, much of which is subject to tax, under pensions freedom and this means that future income streams need to be replaced: a challenging advice scenario. There may well be benefits being foregone other than the pension payable to be taken into account. These include pensions for dependants, ill- health benefits and any lump sum that is paid out on death. It is unlikely that a transfer from a DB scheme to a DC arrangement will be to the advantage of the individual. But it can happen: for example: a highly successful employee who has decided mid-career to build his own business and who wishes to access pension fund monies to buy a property to be held in his new SSAS; a single employee who does not need ancillary benefits and wishes to use his own investment ideas with a series of specialist collective funds which he "knows" will out-perform. (But even in these two examples, the adviser should ensure that risks are highlighted in the Suitability Report and are accepted by the members in return for the gains they expect at the point of transfer.)

Where the individual has a series of DC arrangements there may be an argument for consolidating these arrangements. It will make it easier for the individual to keep track of his or her pension arrangements if they are all in one place, and there may be cost advantages. The management fees paid out to the companies administering these arrangements may be reduced, particularly where a minimum fee is charged regardless of the size of the fund. By having fewer arrangements fewer fees may be payable. Benefits of scale may also come into play, particularly when an individual is looking to convert the pension fund into an annuity. They are likely to be able to choose from a larger selection of annuity providers if their funds are consolidated. But this consolidation of separate pension arrangements into one annuity can occur at retirement in any event. Extra work is required but insurers receiving the monies, while setting up separate annuity tranches, will base their quotations on the aggregate funds available.

The adviser's role in any transfer is to help the individual understand what benefits he currently has, establish that individual's objectives and circumstances, take account of specific features of existing benefits and effect research to see whether or not a better arrangement is available elsewhere. Advantages and disadvantages, costs and penalties must be set out clearly in the Suitability Report.

Advisers need to consider all the above points and time implications such as the recalculation of DB transfer values after three months and the constantly changing values of money purchase arrangements.

Advisers need to ensure they consider the implications of any transfer to an unregistered scheme. Normally such a transfer would not occur as such transfers should generally be avoided but if it were to apply then great care would be needed and the suitability report appropriately qualified.

Summary

This Chapter has summarised the development of transfer values, outlined the legal and regulatory background and considered the recent use of inducement exercises. Note that Pension Liberation Fraud, which depends on the statutory availability of transfer values, is discussed in Chapter 4.

Self Test Questions

- Describe the rights of early leavers to transfer benefits and how they have changed over the years.
- Under what circumstances does a member NOT have the right to transfer his pension rights from one scheme to another?
- Describe what steps employers and trustees must take where the employer intends to offer an inducement to the members of its pension scheme to encourage them to transfer their benefits into a new arrangement.
- Explain how options and discretionary benefits should be taken into account in individual transfer calculations.
- What are the typical signs of pension liberation fraud?
- Outline the factors that might influence a member's decision as to whether or not to transfer benefits into a scheme.
- Explain why the trustees of a registered pension scheme might refuse a member's request to transfer their benefits to a non-registered scheme.

CHAPTER 2

Self Invested Personal Pensions and Drawdown

INTRODUCTION

The origins of SIPP and SIPP drawdown can be traced back at least to the launch of personal pensions in July 1988. Furthermore, in the five years or so preceding that date, new ground was being broken with Small Self- Administered Schemes, occupational schemes where the members could control investments - post-2006, HMRC regard these types of scheme as invested regulated schemes for which the investment powers are set out in rules under the 2006 Finance Act. Prior to 1988, individuals could not set up self-invested schemes without first establishing an occupational pension scheme. Individuals were otherwise limited to retirement annuity contracts which were set up through insurers. But SSASs were taking off, principally because of their investment flexibility: a SSAS could invest in own company shares, purchase fixtures and property from which the sponsoring company plied its business and a SSAS could borrow. SSASs did not have to be insurance company products and the Superannuation Funds Office (responsible for overseeing pensions from the tax viewpoint at that time) offered model rules which SSASs could use and seek approval (approved being the 1980s equivalent of registered).

As a SSAS is not an insurance company product, full SSASs were offered by firms of consulting actuaries in particular because at that time triennial actuarial valuations were required for SSASs. That valuation requirement ceased in 2006, along with the requirement for a specialist "Pensioner Trustee". Many SSASs were set up as hybrid schemes, where an insurer provided actuarial and other services at a reduced or no charge, if the SSAS trustees invested a specified/agreed amount with them.

The growth of SSASs also led to the development of drawdown principles. If a family company had included company shares and property in the SSAS assets, if the business remained a going concern and control was being passed to the next generation, why should company assets be sold? The answer, with the agreement of the tax authorities, was to permit retirement income and tax free cash to be paid in effect out of rental income and other scheme assets. Because the tax authorities were concerned that pensions assets would be dissipated too quickly, actuarial limits were set as to the maximum amounts which could be drawn down each year: this was regulated by the use of the Government Actuary's Department (GAD) limits. When using the GAD tables, a factor is used each month; this is dependent on the rounded down FTSE yield derived from the gross redemption yield on 15 year UK Gilts Indices for the 15th of the month preceding the month in which the income withdrawals commence or reach their review date. Drawdown in its early days was known as "unsecured pensions". But annuities, the DC version of "secured pensions" (DB schemes provide scheme pensions), still needed to be set up by age 75 at the latest – at least that was the intention of the tax authorities.

Meantime, in the background SIPPs were quietly developing. On 14th March 1989, the then Chancellor, Nigel Lawson, announced in his Budget speech: "I propose to make it easier for people in personal pension schemes to manage their own investments". Later that year Joint Office Memorandum 101 gave details of investment rules for personal pensions. SIPPs had arrived.

“Pensions Simplification” in 2006 significantly spurred the growth of SIPP’s and other personal pensions. The removal of maximum percentage limits on contributions based on net relevant earnings, the relaxation of the concurrency rules which had restricted contributions made to personal pensions where occupational schemes were available and the opening up of personal pensions to the same contribution and Lifetime Allowances limits as occupational pensions, all gave a major boost to the SIPP market. Now, with almost the same flexibility of SSASs in all respects, contributions and investments, SIPP’s popularity burgeoned.

2.1 DRAWDOWN

Prior to “Pensions Simplification” in 2006, drawdown availability was limited to what we now call Capped Drawdown: retirement income, ignoring tax-free cash, was capped by the GAD limit already mentioned above. A variation of Capped Drawdown was achieved by splitting the SIPP into different segments, each, in effect, a Capped Drawdown in its own right: considerable flexibility could be achieved by using this cluster of Capped Drawdown segments collectively known as Phased Drawdown.

From April 2006, another version of drawdown was introduced: Alternatively Secured Pension. This permitted drawdown to continue after age 75 and although income was limited within a range of 55% minimum to 90% maximum percentage of the normal Capped Drawdown amounts for a 75-year old, it marked a helpful addition to the flexibility of drawdown: buying an annuity at 75 was no longer mandatory.

Alternatively Secured Pensions were replaced when Flexible Drawdown was introduced in April 2011 and the option for wealthier pensioners to drawdown all of their SIPP funds was also introduced. Ultimate flexibility is now with us limited only by providers’ contracts and, of course, clients’ needs and we consider that in section 2.1.6, Flexi-Access,

Before that we summarise the main versions of drawdown are outlined below together with the concomitant use of annuities.

2.1.1 Capped Drawdown

Under this form of Drawdown, a tax-free Pension Commencement Lump Sum (PCLS), of 25% of the value of the fund (more than 25% if protected tax-free cash rights built up before April 2006 are available) can be taken, as a single lump sum or in tranches. Tax-free cash of less than 25% may be taken; it is an option, but it would be unusual to waive any tax-free cash. (If tax-free cash is not required immediately, then Phased Drawdown – see following description – was probably a better option, before Flexi Access drawdown appeared). The balance of the fund can then be drawn each month (or other frequency not exceeding one year) to provide a regular income: this income is subject to income tax. Alternatively funds may remain invested and withdrawals commenced at a later date.

The maximum amount which can be taken as taxed income depends on prevailing long term interest rates and a formula set by GAD rates. In advising clients, warnings need to be made about the effect of maximum withdrawals on future fund values and income payments. There is no minimum level of withdrawal (drawdowns in earlier years needed to provide an income of at least 35% of the GAD limit). The maximum income level for drawdowns in general, and unexpectedly perhaps, has been set at 150% GAD since April 2014 for new/revised drawdown calculations: prior to that, drawdowns were running at 100% or 120% GAD depending on when the last review calculation was done (see 2.1.3 below for more detail). The maximum withdrawal level on a specific client’s contract is subject to review every three years (the three year period briefly became five years after 2006) prior to age 75 and every year thereafter. This is to check that investment fund performance has been adequate to provide the required level of withdrawals. For clients over the Lifetime Allowance and without an earlier form of transitional protection part of the fund will be subject to a Lifetime Allowance charge

Capped Drawdown members can choose to buy an annuity at any time, if it was felt that annuity levels become relatively high at the time or if the client no longer wished to continue the investment and withdrawal arrangements.

On death before setting up an annuity, the members' spouse/beneficiaries would have the following choices:

- take the remaining crystallised fund as a capital sum, tax-free if the member is under age 75 or subject to the recipient's marginal rate of tax for payments after April 2016 (a flat 55% tax charge applied until April 2015 changing to 45% up to April 2016). This lump sum will generally be paid to the member's nominated beneficiaries and will normally be free of Inheritance Tax
- the member's spouse can continue to take pension fund withdrawals, subject to income tax at the beneficiary's normal rate; the fund would then become a Flexi-Access Drawdown
- purchase an annuity for the spouse (not adult children), subject to income tax at the beneficiary's normal rate
- single members (and married) also have the option of nominating a charity although this is infrequently encountered; payments to charity are tax-free.

Capped Drawdown and Pensions Freedom. Notwithstanding the new freedoms introduced by Flexi-Access Drawdown, Capped Drawdown is likely to remain. This is despite the fact that Capped Drawdown may have limited availability if providers decide not to offer it because Flexi-Access Drawdown is simpler or if Capped Drawdown becomes more expensive to operate because it is more complicated. Some clients may have Capped Drawdown because they have Protected Cash Lump Sums which can be substantially greater than 25% where they have old occupational pension rights. Or they may have a Transitional Protection to a higher Lifetime Allowance which the Government fears could enable them to take additional tranches of tax-free cash: these persons will therefore be unable to access Flexi-Access Drawdown. In their Pensions Flexibility 2015 Taxation and Information Policy Paper published on 10 December 2014, HMRC state "The changes relating to the taxation of payments from a beneficiary's drawdown fund will have effect for any payments of income withdrawal from 6 April 2015 from a drawdown fund, but only where there had been no payments of any drawdown pension from that fund before 6 April 2015." Retaining Capped Drawdown – and the client will need to opt in to that choice provided he had it prior to April 2015 – may also be advantageous (if there is no Transitional Protection) when the client wishes to make contributions to this Capped Drawdown as a registered pension scheme (for Flexi-Access Drawdown, the Money Purchase Annual Allowance limits contributions to £10,000.). This could apply when the client taking Capped Drawdown continues to work and his employer is willing to make contributions (or operate salary sacrifice perhaps). The Government has stated that the existing rules in Schedule 28 FA 2004 will apply to funds added on or after 6 April 2015 to drawdown pension funds that were set up before 6 April 2015 but only where they are used for Capped Drawdown.

2.1.2 Phased Retirement

The old Phased version of drawdown works as follows: all funds are consolidated into one personal pension plan, which consists of separate but identical segments, which can be drawn on separately as required. The member can decide whether to take income immediately and if so, how much. When that amount of drawdown has been chosen, a calculation is then done to find out how much of the total fund is needed to provide the first year's drawdown. This drawdown will consist of a one-off tax-free lump sum from the segment which is being crystallised, together with a taxed income based on GAD limits applied to the remainder of the vested segment. There is also an option for a separate annuity income payable for life using the remainder of the vested (i.e. crystallised) segment. The rest of the pension fund remains invested. The amount of tax-free cash is 25% (more if protected tax-free cash is available) from each segment crystallised. If the segment represents only 10% of the total fund then only 10% of available tax-free cash is used with the balance held over for later years.

In the second year, a decision is again made on the required drawdown and after taking account of taxed income already being received either from the annuity or from continuing drawdown, a further sum is crystallised, part as tax-free cash with the balance from the second year annuity or drawdown income tranche. It is not obligatory to take any tax-free cash or drawdown income at all (though any previously established annuity will still be paid). In each of the subsequent years, the same exercise is repeated which permits considerable flexibility in income to allow for changing needs. For the same reason, changing needs, ongoing reviews are required.

In the advice process it is important to remember to discuss future provision for spouses and dependants.

On death before age 75, any part of the fund not used to purchase an annuity or to fund drawdown (i.e. uncrystallised assets), is available to provide benefits for the member's family. All of the fund may be paid as a lump sum, usually free from Income and Inheritance Tax. Or an annuity can be set up or drawdown continued by the spouse but note that income tax would be payable. That part of the fund which has been crystallised has the same options which apply on death in full Capped Drawdown.

If death occurs after age 75 the spouse/beneficiaries would have the following choices:

- any part of the fund not used to purchase an annuity may be paid as a lump sum to the spouse/beneficiaries at the recipient's marginal rate (a flat 55% tax charge applied until April 2015 changing to 45% up to April 2016)
- income drawdown may be continued
- an annuity could be bought for the spouse/dependant
- single members (and married) also have the option of nominating a charity although this is infrequently encountered; payments to charity are tax-free.

In some ways, Phased Drawdown had already created the income pattern now available from Flexi-Access Drawdown and it is likely that the old-style Phased Drawdown will all but disappear. The new Flexi-Access is simple to operate since the tax-free element of the Uncrystallised Funds Pension Lump Sum payment is 25%. However there are situations where persons with Protected Cash Lump Sums may prefer to retain their existing contracts to maintain that benefit.

2.1.3 Flexible Drawdown

With effect from April 2015, Flexible Drawdown, mentioned in 2.1 above, became Flexi-Access Drawdown: section 2.1.6 below covers Flexi-Access. For the moment we will review Flexible Drawdown.

Perhaps signalling the Government's changing attitude towards large pension funds in particular, a significant change was made in 2011 as to how pension benefits could be paid: the introduction of Flexible Drawdown where there was no GAD maximum income level. It became possible to take as much income as required from one year to the next. Indeed, it was possible to take the whole of the pension fund as a single pension payment (George Osborne's Lamborghini purchase facilitation existed prior to his 2014 Budget: it just was not mentioned in those terms before!). All pension payments were subject to income tax at the highest marginal rate. And the option remained to take no income at all.

To qualify for Flexible Drawdown, it was necessary to evidence the payment of secure pension income of at least £20,000 per annum: the Minimum Income Requirement (MIR). (The 2014 Budget reduced MIR to £12,000 from 27 March 2014.) This secure pension income could be made up of State Pensions, a pension from an occupational pension scheme and income provided through Compulsory Purchase Annuity contracts. Existing drawdown payments, rental income and even Purchased Life Annuities were not deemed to represent secure pension income.

Once Flexible Drawdown was selected it was no longer possible to make further pension contributions without incurring a tax charge; this was to prevent abuse of the new flexibility, whereby someone could take tax-free cash under Flexible Drawdown and then create more tax-free cash under a new pension scheme. The restriction was eased with the introduction of a Money Purchase Annual Allowance of £10,000 in April 2015 applying when pension schemes are flexibly accessed. The Money Purchase Annual Allowance was reduced to £4,000 from April 2017, again to limit perceived abuse.

Flexible Drawdown was only available to scheme members who made a declaration confirming that they satisfied the conditions for Flexible Drawdown and that the declaration was acceptable to the Scheme Administrator. The conditions only had to be met once – they did not need to be applied each time a pension fund was crystallised using Flexible Drawdown.

The scheme member met the Flexible Drawdown conditions if:

- in the tax year that the declaration is made, no contribution had been paid for their benefit to any money purchase arrangement
- as at the date of the declaration the member was not an active member of a DB or cash balance arrangement
- the MIR were satisfied.

Flexible Drawdown introduced a high degree of flexibility and access. But the major disadvantage was that it could very rapidly delete a person's retirement income and in consequence it was very important for a client to recognise this risk and either accept this risk fully and consciously (and for the adviser to ensure that his client was in no doubt about this risk) or have other capital on which to draw to support the desired standard of living. This same risk remains with Flexi-Access Drawdown: a person's retirement income can be very rapidly deleted.

A further disadvantage of Flexible Drawdown was the payment of income tax which is likely to be at the highest rate of tax, up to 45% (and even at 60% for that tranche of income where the Personal Allowance is lost as taxable income exceeds £100,000). This disadvantage is also shared by Flexi-Access Drawdown. Bear in mind too that pension funds have tax advantages in that they are largely free of Capital Gains Tax and also enjoy favourable Inheritance Tax treatment. Removing funds from a registered pension scheme can therefore result in higher rates of Income, Capital Gains and Inheritance Tax. Could this higher tax yield have been a factor in the Chancellor's apparent generosity? These same considerations need to be applied to Flexi-Access Drawdown. On 25 June 2015, the Daily Telegraph reported "Older savers are using the new pension freedoms to withdraw almost four times more money than the Treasury anticipated, providing an estimated £1.2 billion tax windfall".

Whilst Flexible Drawdown did, and while Flexi-Access does, open up the access to pension funds, it also has a detrimental effect on future income, even removing it altogether. An obvious point but it must be spelled out to the client in Suitability Reports. (And the removal of future income has become even more significant now the need for any annuity or income has been removed from April 2015 – see next Chapter.)

2.1.4 Drawdown Using Fixed Term Annuities

A fixed term annuity contract is also an option under drawdown (in addition to the lifetime annuity option mentioned in the Capped Drawdown section). This will pay you a fixed income each year, typically over a five to ten year term. The amount each year will be a pre-set amount. Unlike income drawdown proper, the member cannot choose to change the amount each year (over and above any built-in changes).

The maximum amount depends on GAD rates in Capped Drawdown though for Flexi-Access we have seen the removal of restrictions on the amount of and term of annuity. The flexibility for taking pension funds introduced from 6 April 2015 has increased the interest in fixed period annuities. Providers are increasingly marketing contracts which offer this facility.

Mortality cross-subsidy could help to increase the amount of lifetime annuity with a fixed term annuity of five years or fewer, but the cross-subsidies at this age are very low.

A short-term annuity can continue past the 75th birthday and a fixed term annuity can be bought after age 75.

With a fixed term annuity the member can choose one that is guaranteed to make payments for a set period such as a five-year guarantee.

2.1.5 2014 Budget, 2015 Budget and Conservative Party Conference

Although the industry had seen limited introductions of flexibility with Alternatively Secured Pension and Flexible Drawdown, no-one expected the changes which were to come in 2015.

The Treasury's post-Budget information leaflet, *Budget 2014: greater choice in pensions explained*, confirmed relaxed access with effect from 27 March 2014, to DC pensions as follows:

- MIR reduced from £20,000 to £12,000 p.a.;
- capped drawdown limit increased from 120% to 150% to permit greater flexibility;
- the size of a single occupational pension pot that can be taken as a lump sum increased from £2,000 to £10,000 (and the number of such pots which can be taken as a lump sum increased from two to three);
- trivial commutation pension pot limit increased from £18,000 to £30,000.

These were important relaxations in the rules giving greater access to pension funds and greater flexibility in drawing benefits (though the last two were concerned not with drawdown but with trivial pensions). What followed for the subsequent year was not anticipated.

Two highly significant and unexpected statements were made by the Chancellor, George Osborne in his 19 March 2014 Budget and later on 29 September 2014 at the Conservative Party Conference.

In his Budget he announced *"We will legislate to remove all remaining tax restrictions on how pensioners have access to their pension pots. Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, anytime they want. No caps. No drawdown limits. Let me be clear. No one will have to buy an annuity."*

At the Conservative Party Conference, he said *"There are still rules that say you can't pass on to the next generation any of your pension pot when you die without paying a punitive 55 per cent tax on it. I could choose to cut this tax rate but instead I choose to abolish it altogether... effective from today."*

The Budget announcement in particular widened the choices for all people at retirement, especially for those with defined contribution (DC) pension schemes. But the September statement had particular significance for High Net Worth clients many of whom have Drawdown contracts. The effect on Drawdown clients is considered in the next section.

The far-reaching changes introduced in this section significantly change the drawdown playing field. The next two sections cover these.

2.1.6 Flexi-Access Drawdown

Flexi-Access Drawdown is a major change and part of the Chancellor's pensions freedom reforms. Central to this change affecting the withdrawal of pension funds by the member is the Uncrystallised Funds Pension Lump Sum. Taking UFPLS means that Flexi-Access "Drawdown" is regarded as having started. The taxed lump sum is taken from the existing unvested fund: it is treated as a single payment by itself made up of 25% tax-free and 75% taxed as income.

Payment of UFPLS also triggers the £10,000/£4,000 Money Purchase Annual Allowance which might be an issue for clients wishing to continue to make contributions up to the £40,000 Annual Allowance.

The UFPLS is available to most people though not those with enhanced tax-free cash rights which might arise through Primary or Enhanced Protection or entitlement to pre -2006 tax-free cash exceeding 25%. It is also unavailable to beneficiaries following the member's death.

If a client in Capped Drawdown exceeds the GAD cap then his plan will default to a Flexi-Access Drawdown arrangement.

2.1.7 Revised Death Benefit Terms

The further far-reaching change concerns death benefits on the member's death. On death up to age 75, lump sums are no longer taxable, even if they arise from vested funds. This applies for payments made from 6 April 2015 and applies to both Capped Drawdown and Flexi-Access Drawdown.

Even on death after age 75, the tax rate is reduced as shown in the below. The following table sets out the position before and after April 2015:

| Tax Lump Sums on death ... | Age, pre-75; unvested fund | Age, pre-75; vested | after age 75, (fund vested or unvested) |
|----------------------------|----------------------------|---------------------|---|
| before 6 April 2015 | 0% | 55% | 55% |
| after 5 April 2015 | 0% | 0% | 45% (until April 2016 and marginal rate Income Tax from April 2016) |

Notes: the tax-free payment of the lump sum is contingent on payment being made within two years of the Scheme Administrator being aware of the member's death (so if this period is overlooked, the advice should include consideration of taking a taxed income spread over a number of years, perhaps to avoiding higher rate tax) the financial adviser and client should almost certainly ensure that the fund is NOT taken in instalments otherwise HMRC would be able to regard these instalments as income, which would probably give rise to tax the option for annuity purchase (or scheme pension – a scheme pension is an agreed series of income payments for life set up within a pensions scheme, generally in defined benefit schemes but occasionally met with in drawdowns) remains

Where beneficiaries take the fund as income the pre-75 position is improved as shown in the table below.

| Pensions on member's death ... | Age, pre-75; unvested fund | Age, pre-75; vested | after age 75, (fund vested or unvested) |
|--------------------------------|----------------------------|---------------------|---|
| before 6 April 2015 | Income Tax | Income Tax | Income Tax |
| after 5 April 2015 | 0% | 0% | Income Tax |

Further, the class of beneficiaries is extended, by the Taxation of Pensions Act 2014, to in effect permit the cascading of wealth down the generations although this wealth will be drawn subject to income tax on the beneficiary and there is no further tax-free cash. The new beneficiary classes of Nominee and Successor are added by the Taxation of Pensions Act.

The pre-existing class, Dependant, remains. A member can leave funds to a Dependant or Nominee, while a Nominee can leave funds to a future Nominee or to a Successor.

The existing definition of Dependant continues to apply, being someone who was married to or a civil partner of, the member at the date of the member's death. A child of the member is someone who has not reached the age of 23 or, if they have, remains in full time education or was dependent on the member because of physical or mental impairment. The definition also includes a person who was financially dependent on the member, had a financial relationship with the member through mutual dependence, or was dependent on the member because of physical or mental impairment. If the lump sum is not paid out as cash, the Dependant becomes the beneficiary of a Dependant's Flexi-Access Drawdown fund. The creation of a Dependant's Flexi-Access Drawdown fund from uncrystallised funds is a new Benefit Crystallisation Event which triggers Lifetime Allowance testing.

A Nominee is a person, not a dependant of the member, who is nominated by the member to be considered as recipient of a Nominee's Flexi-Access Drawdown fund: non-dependent children or grandchildren are obvious candidates for this benefit. A Scheme Administrator is also able to nominate but only when there are no dependants of the member, no individuals nominated by the member and no charities nominated by the member. This is another reason for financial advisers to ensure that an Expression of Wish form is in place and agreed with member. The creation of a Nominee's Flexi-Access Drawdown fund from uncrystallised funds is a new Benefit Crystallisation Event which triggers Lifetime Allowance testing.

A Successor is a person nominated by a beneficiary to be considered for a Successor's Flexi-Access Drawdown fund on death of the beneficiary. As with nominees, a Scheme Administrator can also name a Successor but only when there are no individuals nominated by the member and no charities nominated by the member. Again, this is another reason for financial advisers to ensure that an Expression of Wish form is in place and agreed with member.

Note that where a Scheme Administrator makes a payment to a charity, this charity must have been named by the member or beneficiary. It is also not possible for any payment to be made to charity where there are Dependants even if the member did not make any nomination by Expression of Wish.

2.2 LIFETIME ANNUITIES

When considering drawdown options with clients the availability of and choices surrounding lifetime annuities should always be mentioned as an alternative. This should be both as an alternative to continuing the drawdown as a whole and in their use for the income option when a segment of the contract is crystallised. This mention is usually made as part of a Critical Yield analysis.

There are different types of lifetime annuities to suit client's needs and circumstances and the Suitability Report should explain how these lifetime annuities work. The following annuity features should be covered:

- a lifetime annuity can provide an income for the remainder of a client's life
- annuity providers regularly adjust the annuity rates they offer. This is principally due, but not limited to, changes in the average life expectancy and, in particular, current interest rates available
- once a client has purchased a lifetime annuity he is locked into the rates offered at that time. This means that the amount of payment will not be affected if rates fall; conversely they will not benefit from future rate rises.

The amount of income an annuity pays depends on, amongst other things:

- the amount the client has in his pension fund
- the amount of Pension Commencement Lump Sum or tax-free cash-if UFPLS
- the client's age
- where the client lives (in certain cases)
- the client's health (in certain cases)
- benefits chosen, including whether the annuity is for the client or client and partner (we look further at benefits chosen in Annuity Options below).

The older a client is when an annuity is purchased, the higher the starting income tends to be. This is because, on average, an older person has fewer years left to live than a younger person. However, care must be taken in advising clients if they are considering or if you are recommending delaying the purchase of an annuity in order to take advantage of rates rising with age. Improving longevity in general and interest rate changes can both affect an annuity rate much more than an improvement resulting from a client being, say, 12 months older.

2.2.1 Annuity Options

These options will be relevant for drawdown clients as possible alternatives to their existing pensions structure. If an adviser is providing advice to actually set up an annuity then a further up-to-date supplementary fact-find is required.

Single-life or joint-life. Unless there is a guaranteed payment (see Guaranteeing Annuity Payments below), a single-life annuity will only pay out during the client's lifetime. A joint-life annuity will continue to pay an income to a client's partner or dependant after death. If the client is not married or is in a civil partnership, further questions need to be raised with the new provider to ascertain that the partner or dependant will be eligible to receive an income from a joint-life annuity: this would mean the annuity would then be set up on a named dependant basis. It may also be possible to obtain a better rate by setting up a joint life annuity for a legal spouse on a named dependant basis. This is because an "any spouse" joint-life annuity could be paid either to the legal spouse to whom the client was married at the date the annuity was set up or to any subsequent spouse following, say, remarriage on the premature death of original spouse. Joint-life annuities will be more expensive than single-life annuities as the insurer will expect to continue payment of the annuity for a longer period. The amount of the joint life annuity which is received by the spouse can be arranged to reduce on the client's death. This will mean that a higher starting pension will be available for both the client and his spouse to enjoy. The amount of the reduction is usually one-half, but other reduction factors are readily available. The reduction amount should be agreed with the client. Note that the age of the spouse/dependant will affect the amount of joint-life annuity: a younger spouse will be assumed to live longer; hence the starting pension will be lower. If an "any spouse" joint-life annuity is set up then the insurer is likely to reduce the contingent pension if the surviving spouse is ten or more years younger than the client.

Level or escalating lifetime annuities. A level lifetime annuity pays the same income every year for the rest of the client's life. This will produce a higher starting income than an escalating annuity but what the client can buy with the income will fall as inflation increases prices over time. This may suit clients who wish to have more money in the earlier stages of retirement to enjoy holidays and hobbies but for clients wishing to protect income from rising prices (concerned about rising home care costs perhaps), the client can opt for an escalating annuity which pays a lower initial annuity but then increases each year.

Escalation can be set on a fixed-rate basis, where income is guaranteed to increase at a pre-determined rate each year: e.g. 3%, pa compound. Or it can be RPI-linked escalation, where the client's income is adjusted each year in line with the Retail Prices Index (RPI). There are many variants: 5%pa compound is a popular increase factor but many providers will quote for any rate of escalation. The RPI-linked option may have a guarantee built in so that it does not fall if RPI falls (normally an RPI-linked pension would fall as well as rise). Other indices can also be used with the provider's agreement instead of RPI: e.g. Consumer Price Index. With an escalating annuity, the starting income will be lower than a level annuity and it will take a number of years before the income level has caught up in payment amount and even longer before the same aggregate monetary value has been delivered (the student could refer to the Time Value of Money section in Part 3 and consider real value here as well as monetary value).

Impaired life and enhanced annuities. If a client has a health problem that threatens to reduce lifespan, it is increasingly likely that providers will offer an impaired life annuity. Some providers have recently (within the last decade or so) entered the annuity market specifically to provide impaired/enhanced terms. Relevant health problems may include cancer, heart attack, high blood pressure, stroke, chronic asthma, diabetes, kidney failure or multiple sclerosis. An enhanced annuity can be offered if the client is overweight or has smoked within the last ten years. Or even if the client has worked in certain occupations or lives in a certain part of the country (postcode information is used by the provider in this). The adviser should not overlook such factors if setting up an annuity is an option being considered. Even taking regular medication may be a factor which means an annuity rate could be enhanced.

Guaranteeing Annuity Payments. To ensure that an annuity does not terminate prematurely in the event of premature death, the adviser should discuss the follow options with the client:

- guaranteed payment periods: usually for five or ten years' worth of income, where on death the income will continue to be paid for the rest of the guaranteed payment period chosen. This option might be an acceptable alternative to a joint-life annuity, but it would probably be unsuitable if the income is needed for a longer period by a widow(er). Pensions freedom has also meant that the lifetime payment requirement for an annuity as well as the maximum term on guaranteed annuities no longer apply even outside the drawdown context. Discussions need to be held with the client to determine requirements and to explain advantages and disadvantages
- annuity protection lump-sum death benefit: this pays a lump sum to beneficiaries on your death, equivalent to the pension fund used to purchase the annuity, minus the income received. A special lump sum death benefit tax charge of 55% was made on such payments but from April 2015 this rate changed to 45% and marginal rate applies from April 2016. There may also be an Inheritance Tax liability on this payment.

Investment-linked Annuities. Investment-linked annuities place the assets of a pension fund into investments, meaning that clients continue to use stock market investments after retirement. With this option there is always the risk that the value of investments could fall. With an investment-linked annuity, income will be linked to the expected return of the investment and, as such, can rise and fall unlike a pre-set income through a lifetime annuity.

Investment-linked annuities can be either with-profits or unit-linked:

- with-profits annuities – if a client opts for a with-profits annuity, the pension fund is linked directly to the performance of the insurer's with-profits fund. Income is usually made up of a low level starting income (sometimes guaranteed by the insurer) and annual bonuses. Bonuses are not guaranteed and will depend on a number of factors including the financial strength of the firm
- unit-linked annuities – if a client opts for a unit-linked annuity, the pension fund is invested in the investment funds chosen and income will be linked directly to the performance of these funds. The higher the risk of fund chosen, the more income is likely to fluctuate up and down.

2.3 REGULATORY REQUIREMENTS

Both the FCA (following on from the PIA's RU55 and RU67) and the Association of British Insurers have issued guidance to their members regarding the care they must take when advising a client about income withdrawal.

FCA Handbook

Before advising on income withdrawals the following instructions given in the FCA Handbook regarding the client circumstances should be considered.

COBS 9.3.3 Income withdrawals and short term annuities

When a firm is making a personal recommendation to a retail client about income withdrawals, uncrystallised funds pension lump sum payments or purchase of short-term annuities, it should consider all the relevant circumstances including:

- (1) the client's investment objectives, need for tax-free cash and state of health;
- (2) current and future income requirements, existing pension assets and the relative importance of the plan, given the client's financial circumstances;
- (3) the client's attitude to risk, ensuring that any discrepancy is clearly explained between his attitude to an income withdrawal, uncrystallised funds pension lump sum payments or purchase of a short-term annuity and other investments.

COBS 9.4.10 Additional content for income withdrawals

When a firm is making a personal recommendation to a retail client about income withdrawals or purchase of short-term annuities or making uncrystallised funds pension lump sum payments, explanation of possible disadvantages in the Suitability Report should include the risk factors involved in entering into an income withdrawal or purchase of a short-term annuity or making uncrystallised funds pension lump sum payments. These may include:

- (1) the capital value of the fund may be eroded;
- (2) the investment returns may be less than those shown in the illustrations;
- (3) annuity or scheme pension rates may be at a worse level in the future;
- (4) the levels of income provided may not be sustainable;
- (5) there may be tax implications.

2.4 COMPARISON OF DRAWDOWN TO ANNUITIES

| Potential advantages of Drawdown | Potential disadvantages of Drawdown |
|---|---|
| <ul style="list-style-type: none"> • There is no need to make an immediate decision about spouse's, civil partner's or dependants' benefits. • The client can vary income to meet personal requirements and to manage their tax situation. • There is a possibility of benefiting from a higher annuity rate when (and if) a lifetime annuity is eventually purchased, either through a general increase in rates or by the member now being able to benefit from an impaired life annuity. • Death benefits are flexible in format and can be left to a wide range of beneficiary. • There is the potential to benefit from investment growth of the underlying fund. | <ul style="list-style-type: none"> • It is more complex than the secured alternatives, requiring regular reviews; this complexity incurs costs. • Annuity rates in the future may decrease. • The charges within the Drawdown contract are higher than under the secured alternatives. • The fund may reduce in value due to poor investment performance or may be eroded due to income withdrawals. • Loss of mortality gain. |

2.4.1 Risks of Drawdown

Planning Risk – A very important point for advisers to bear in mind in dealing with any drawdown strategy, particularly now we have Flexi-Access, is the amount of income required and the effect this may have on the fund. Taking a fixed income from a fund invested in assets which show volatility may have unfavourable consequences. Just as £ Cost Averaging can benefit the build up a fund into which fixed contributions are being made when long-term values rise, a fixed income taken from assets which are falling, even if only over a period of a few years, can have a significant depletory effect on a fund into which no further contributions are being made: this is sometimes referred to as £ Cost Ravaging.

Client needs should be considered very carefully initially and reviewed against both needs and available assets at regular intervals. The importance of sustainable long-term income, cash for immediate spending and leaving funds for dependants and family members are three important but mutually exclusive aims.

Interest Rate Risk – Annuity rates may remain low or even deteriorate during the period of income withdrawals, leaving the client in a considerably worse position than if an annuity had been purchased at the outset. This assumes that the client's intention is to buy an annuity in due course.

Investment Risk – The invested portfolio may perform poorly, or the fund may be depleted too rapidly by excessive withdrawals. Income needs to be sustainable. One way to manage this and deliver the chosen income for the client is to maintain a cash "float" equivalent to, say, 18 months' income. This float could be topped up if markets in which assets are invested appear to be near their peak. Another way could be to buy an annuity with a small part of the assets when they appear to have peaked to give the client an underlying income which will help to reduce future risks to sustainable income.

Sequencing Risk – The sequence in which asset values rise and fall is also very significant. If a client is drawing a steady income, then if the investment values fall in the first five years of retirement and then rise over the next five years, the negative impact on the fund at ten years will be significantly higher than if the assets rose in the first five years and then fell over the next five. This is because capital is eroded more quickly when assets are lower.

Mortality Risk – Compared with annuity purchase, there is no cross-subsidy between those who die early and those who live longest. An annuity will benefit from the earlier death of some of the annuitants because of that cross-subsidy. A person "going it alone" with their own drawdown will not receive this cross-subsidy: thus the drawdown return compared to an annuity return will be dragged back comparatively: this is known as mortality drag. The investment performance of the fund must make up for this loss of subsidy, and this may not be achieved. Mortality Risk can be regarded as the risk of financial loss if you die too soon and have not benefitted from the mortality gain implicit in annuity purchase. However, much of your fund will still be intact on early death, which could be acceptable for some clients who wish their dependants to benefit from that fund. The availability of a residual fund can be regarded as a quid pro quo for mortality drag/Mortality Risk.

Longevity Risk – The other side of the Mortality Risk coin where you do not know when you are going to die, is that no-one knows how long they are going to live. This can present severe financial problems for the client himself. As annuities fall in popularity and because Flexi-Access Drawdown means that large withdrawals may be made in the early years of retirement, the risk of the pension fund running out has increased. Income will depend on there being monies within the drawdown pot and the on-going income amount will also be determined by the amount left in the fund. Consequently if a client is relying on income for the rest of his life then client needs need to be very carefully managed particularly if significant funds are invested in real assets which will show volatility but which have been selected for longer term growth. Longevity Risk is closely linked with the Planning Risk

Costs – Drawdown pension often involves high administration and advice charges, and can therefore normally be recommended only where the fund is large enough to absorb them. Most providers stipulate a minimum fund of about £100,000 after taking the lump sum. Some advisers may feel that twice that amount is needed to make a drawdown viable. Other firms, which do not give advice but nonetheless encourage drawdown investments to be placed with them, may stipulate a much lower fund. The adviser will need to guide his client through these options

2.4.2 Variable Annuities

A limited number of insurance companies, often with American parents, have been offering products which provide some income guarantees for drawdown plans. These go under several different names including 'third way' products and their US label, 'variable annuities'. They can be regarded as hybrid contracts sitting between Capped Drawdown and Lifetime Annuities drawing on advantages and disadvantages of both. Their use needs careful consideration at the personal recommendation stage.

When initially launched, these types of plan gave an initial guaranteed annual single life income of perhaps 5% of the initial fund value (4.5% for a joint life). However, the providers have re-priced variable annuities and the corresponding guarantees now look to be settling 1.5% lower, i.e. 3.5% for a single life under 65 and 3% for a joint life. Some of the insurers have withdrawn from the market. The adviser will need to be circumspect with these types of provider: for how long will they remain in the market as competitive providers?

Once the variable annuity is established, the plan is reviewed on a regular basis (e.g. annually) and if the fund value is higher at the review date, then the guaranteed income increases to the guaranteed percentage of the then fund value. If the fund value is less at review, the income amount is unchanged. The same ratchet approach applies to death benefits. The main points to note about these plans are:

- they are subject to the normal drawdown pension income rules
- usually the investment funds (or portfolios of investment funds) that can be selected are limited to reduce the cost of the guarantees (N.B. if the providers did not do this, the adviser and his client would be able to pick risky funds: if they performed well, great; if not it would not matter given the operation of the guarantee.)
- the guarantees are paid for by additional charges, typically around 1%-1.5% p.a. of fund value. Whether these charges represent value for money is a matter of some debate.

The take up of these products was significant in 2008, when £1.15bn was invested in variable annuities. In the second half of 2008, two major UK companies deferred their launches of new variable annuities, citing the difficulty of pricing such products in extremely volatile markets. The same problem led to the reduction in guarantee levels for new plans as described above. Across the Atlantic, in 2008 some US variable annuity providers were forced to raise additional capital to cover their guarantees. In 2009 one of the early providers of variable annuities in the UK withdrew from the market. As a consequence, variable annuity sales fell sharply in the third quarter before recovering somewhat in the final three months. It is probably fair to say that the expectations (of some at least) for the development of third way annuities have not been fulfilled. But they remain as a niche market which can provide some guarantees within the drawdown market.

2.4.3 Suitability of Drawdown Pension Income Withdrawals

Income withdrawal is likely to appeal to clients who are able to accept the risks involved with drawdown: it includes those who:

- are relatively young at the time they want to start drawing benefits
- require the tax-free Pension Commencement Lump Sum, but do not need the level of income an annuity would provide or, possibly, do not require any income at all currently (note that the PCLS is not the same as the 25% tax-free element which is part of an UFPLS)
- are not heavily dependent on pension income and can therefore accept fluctuations in the amount of income they receive from the plan
- wish to preserve the fund for dependants or their children/grandchildren
- require a flexible income perhaps as part of tax-planning considerations
- consider that annuity rates are only temporarily low
- wish to avoid buying an annuity perhaps because they perceive that insurers might make windfall profits on their premature death (the adviser here should ensure that the concept of mortality gain is explained).

Paradoxically perhaps, whereas before April 2015, pension drawdown was often viewed as the risky alternative to annuities and avoided by some clients, Pensions Freedom and Flexi-Access Drawdown have provided a total encashment alternative which makes pensions drawdown appear more attractive. Whichever course is adopted as the most suitable for clients, it should be justified in the Suitability Report.

Summary

This Chapter has covered SIPP's and drawdown as well as the use of annuities in connection with these options.

Self Test Questions

- Identify five main risks in drawdown.
- What is Phased Retirement?
- What are the main types of annuity?
- What is Flexible Drawdown and how has Flexi-Access Drawdown changed this?

CHAPTER 3

Current Developments

INTRODUCTION

This Chapter considers current developments that are relevant in the context of pensions and retail investment advice.

3.1 PENSIONS DASHBOARD

For some years, there has been increasing interest shown by the industry and industry commentators in a “Pensions Dashboard”. Efforts have long been made by some DB schemes to include State pensions benefit in their members’ pension forecasts and many decades ago a few schemes practised “integration” where the Basic State Pension was offset from a two-thirds final salary target. The Government also started issuing State Pension Forecasts in 2001 which helpfully combined Basic, Graduated and SERPS benefits.

The idea of taking all pensions into account is not new. Indeed before the Lifetime Allowance was introduced in 2006 (and advisers need to be mindful of this if they do not want their clients to pay the excess 55% LA charge) it was good practice for pension consultants and administrators to collate information on “retained benefits” to ensure an individual’s overall pensions benefits did not breach approval requirements and give rise to over-funding and consequent return of funds to a (former) employer’s pension scheme. However the means to obtain, record and use all this information did not exist.

On the non-pensions front providers and advisers for some years have been collating all investment data for a client and presenting this, probably within a wrap/platform, and it is perhaps inevitable that impetus has now been given by the Government. The Department for Work and Pension is aiming to bring all the 64m different pension pots in Britain under one roof so that individuals can see all their entitlements in one place. The Pensions Dashboard will bring all pensions online from 2019, showing individuals their pension scheme entitlements from different employers as well as their State pension entitlements. It will integrate data from hundreds of different pension organisations as well as the National Insurance database. On 19 October 2017, the pensions minister, Guy Opperman, called the project “revolutionary”, adding: “A well-designed and thought through Pensions Dashboard has the potential to enhance consumer engagement and help people make better decisions. We want to maximize people’s engagement in their pensions while maintaining their trust. We will ensure that consumer interests are properly safeguarded and their information protected.”

Significant background work has already been done by the ABI and responding to the confirmation that the Department for Work and Pensions will take forward the development of the Pensions Dashboard, the ABI’s Director General said: “I am delighted the Pensions Dashboard is being taken forward by the Government and that the hard work of the ABI and our partners to deliver a prototype will now be continued. A Pensions Dashboard is vital to helping workers keep track of their pension savings as they move employment as well as helping them track down lost pension pots likely to be worth billions in total. The long-term savings industry will work closely with the Government on the next steps to help make this scheme a success for customers.”

So far, the initiative has drawn upon the input of 16 pension firms, six technology companies and regulators. Much work remains to be done on this project which will be a huge IT challenge. Whether the 2019 launch date will be achieved remains to be seen. And we do not know how much will be covered, since every provider and every scheme will need to submit information.

3.2 FUTURE CHANGES

Two significant changes have been mooted but currently have been deferred. They may be introduced at a later date. They are considered below.

3.2.1 Pot Follows Member

The former Pensions Minister, Steve Webb, was keen to create the conditions where members' total accrued benefits are all used to maximise their retirement income and not left as small funds which could be commuted on the grounds of triviality. With this in mind, there has been a proposal that when a member leaves a pension scheme with accrued pension rights below a set threshold (a figure of £10,000 has been mooted) their pension rights will be automatically transferred to the scheme of their next employer. This proposal, commonly known as 'pot follows member,' is intended to allow accrued pension rights to aggregate into a single pension scheme. This would keep a member's fund in one place and where appropriate allow an annuity to be bought on more favourable terms than would apply in the case for a series of smaller funds and so improve individuals' retirement outcomes.

It should be noted that 'pot follows member' would only apply to small funds; the transfer of larger funds would, as now, be instigated by the member. A major factor in this initiative is the expectation that automatic enrolment when fully operational will precipitate a significant increase in the number of small pension pots. The reduction to 30 days of the period during which a member can take a refund is a related factor: once the transitional period where members could take a refund with less than two years' service has expired, by October 2017 refunds will not be available to anyone with more than 30 days' service.

The DWP issued a consultative document in February 2015: Automatic Transfers: A Framework for Consolidating Pensions. Pot Follows Member was due to come in from autumn 2016, when workers would initially have been offered the option of consolidating their pension pots, before an automatic system was rolled out. Under the plans, automatic transfers would first apply to a limited number of larger schemes. The first stage would be to introduce automatic matching of an individual's mini pots. A person would then be contacted to confirm if they wanted these pots to be moved to their new scheme – with an initial opt-in system introduced ahead of a full opt-out model. However Ros Altmann, the Pensions Minister who replaced Steve Webb deferred the Pot Follows Member plans given the huge amount of other work needed in pensions, not least the large numbers of companies automatically enrolling and the concerns around Pensions Freedom.

3.2.2 Sale of Annuities

Steve Webb, when he was Pensions Minister, introduced the idea of consumers being able to sell their annuities even if they were in payment. This was regarded as part of pensions freedom: if people coming up to retirement were able to surrender all their pension for a cash sum (subject to tax) then why not persons who had already set up annuities or even persons in receipt of DB pensions: The Government has indicated that this right may be made available by April 2017 but Baroness Ros Altmann, who replaced Steve Webb, indicated that this solution would not be right for most pensioners and also expressed concerns about the volume of other pensions issues that are taking up the time of insurers, advisers and trustees. Baroness Altmann resigned on 18 July 2016 saying that "short-term political considerations, exacerbated by the EU referendum, have inhibited good policy-making". Her former role is now undertaken by an Under Secretary of State, so this implies that "Pensions" is not regarded by the new Government as important as it has been previously.

Assuming that Sale of Annuities is introduced, advisers and their customers will need to consider carefully the value being offered in return for the existing stream of annuity/pension payments and the tax which would arise. The value issue would depend on the terms offered and it would be for the Actuary to the insurer or trustees who would determine these terms which would not necessarily be beneficial to the person surrendering his current income stream. Receipt of a significant lump sum in return for that stream of income payments would be likely to give rise to higher and additional rates of tax in the tax year in which encashment arose. A further way for existing annuitants to raise cash would be to sell their annuity on the secondary annuity market which could perhaps develop if this option is formally introduced.

However providers expressed concern that only persons in poor health would wish to surrender their annuities which would mean that the remaining annuities would be paid longer. This in turn precipitated pricing concerns for providers with many indicating that they would not agree to buying back annuities – at least on terms which were reasonable for customers. Even though the intention had been to introduce the sale of annuities in April 2017, concerns about consumers getting value for money precipitated, in October 2016, the Treasury announcement that the idea of a secondary annuity market would be abandoned.

Summary

This Chapter has provided a brief update on a number of current developments. By definition they are developments subject to further change as they are implemented. Furthermore, we can expect more changes to follow.

Self Test Questions

- What is the advice gap?
- What is meant by “pot follows member”?