The TAMRIS Consultancy

Comments on Point of Sale Disclosure for mutual funds and segregated funds by the Joint Forum of Market Regulators

Excerpt Fair Dealing Model Concept Paper – January 2004

"The OSC continues to regulate dealers and their representatives through the products they sell, based on an outdated assumption that transaction execution is the primary reason people seek the services of the financial services industry. In today's financial markets, advice is what most people seek, and what most firms emphasise in their marketing messages".

The Joint Forum of Market Regulators have recently released their proposals for point of sale disclosure for mutual fund and segregated fund sales.

The stated objective of proposed framework 81-406 was noted in the proposal as being "*We want investors to have a basic and **correct** understanding of the potential benefits, risks and costs of investing in a fund and to be able to meaningfully compare one fund with another.*" The TAMRIS Consultancy does not believe the objectives have been achieved nor can they hope to be achieved under the limitations of a stand alone Key Fund Facts document.

The "Point of Sale" disclosure document for mutual funds succinctly points out the main objectives of the fund, the top 10 holdings, the sector allocation and past performance after annual management expenses. It also provides an undefined reference to the risk of the fund, for whom the fund would be suitable and information on the range of transaction costs but fails to disclose trailer fees (percentages) for an undisclosed reason. Aside from the simplicity of the document, there is nothing groundbreaking here.

If all the key facts document was intended to do was to help the consumer better understand the "recommendations made by their advisors" at the point of sale (as opposed to having to read a "Simplified Prospectus" at the point of sale) then the document may have some merit.

However in the absence of documentation explaining the limits and responsibilities of the services investors have contracted for and a formal confirmation of the rationale for the recommendation (s) (or suitability letter[1] or report) there is a very real risk that the document will end up subverting the integrity of the suitability process. This is important because the only other mandated document is the simplified prospectus and this document is mostly generic, impersonal, fairly complex and of limited value if responsibility is to be shouldered by the client.

> It is important to note that a strategy (defined by the interaction of a suitability process with a firm's investment discipline) is a higher level recommendation that precedes and supports individual recommendations whose sum (funds and other securities) is of far greater importance than the individual parts. Yet a "key facts" for the strategy/suitability is non existent!

Why should we be concerned? The industry already erroneously uses the mere signing of a client account agreement (*which is no more than an information gathering and account opening exercise*) to support unsuitable security selection and strategy. Since the key facts document is information specific to the

[1] http://www.fsa.gov.uk/pages/Doing/small_firms/advisers/FAQ/letters.shtml

transaction pursuant to a client account agreement or KYC, it is only logical to assume that these documents will likewise be used (incorrectly) to enforce an "explicit" acceptance of recommendations made. This would risk obviating the advisor's responsibility to justify the suitability of a transaction.

Suitability is a cornerstone of the wealth management industry but it is a corner that is clearly and consistently being cut in the interests of the transaction. The key fund facts documentation is in truth a transaction and not an advice driven imperative that looks to reinforce the client's responsibility for the transaction decision[2], as opposed to the institutions responsibility for instituting processes and standards that deliver suitable investment solutions.

In this context, we need to be clear of at least three things.

1. Does the Point of Sale documentation provide all the information needed to assess the suitability[3] of a transaction recommendation? In other words, is the document substantive enough to unequivocally shift responsibility for the solicited transaction recommendation to the client's acceptance?

2. If the documentation is likely to be used against the client in any future complaint against the suitability of the recommendation, then the importance of the document in this context needs to be clearly marked on the front of the documentation. If this document is shifting responsibility to the client they need to know, they need to read the document and they need to ask questions that will help them understand the document. This process would however inevitably create a logical loop back to the need for greater definition of service and suitability. Ergo, we will ultimately need documentation defining the limits and responsibilities of the service and a rationale for and explanation of the suitability of the product.

3. Does the client possess the expertise, resources and systems needed to define a strategy and a structure capable of integrating the transactions recommended into a wealth management solution that optimises the management of risk and return given their risk profile and investment objectives?[4] Clearly not!

We know for a fact that there are no risk warnings, nor any cues to relate this document to the suitability of the recommendation. Without such this document is just as likely to be passed off as a simple administrative hurdle. Indeed, reading the proposals and supporting appendixes it is clear that a benign simplicity (*a small hurdle more appropriate to a simple exchange of information than responsibility*) has been a guiding theme throughout.

Without any written confirmation of the suitability of the recommendation (*why it meets the client's risk profile and investment objectives and where it fits into the portfolio*) it is impossible for the client to confirm acceptance of the suitability of the recommendation. All the client can do is to confirm that they understand the basics of the investment with information which would be insufficient for a professional to make an asset allocation or security selection decision. The simplicity of the document implies a heavy reliance on the investment advisor for advice and the financial institution for due process.

[2] The TAMRIS Consultancy believes that investors should be responsible for the decisions they make, but that they can only be responsible where the services being offered are clearly understood and where there is a well defined process governing the generation and implementation of suitability. Trying to enforce responsibility for the transaction onto the investor in the absence of a clearly defined service and suitability process is impossible, inappropriate and unrealistic.

[3] In order for the client to accept responsibility for the suitability of the transaction based solely on the Point of Sale documentation they need their own processes capable of generating suitable wealth management solutions.

[4] The vast majority of investors clearly do not possess this expertise. The large financial institutions do and they promote this fact, which is why investors seek advice from these institutions' advisors.

Analysis of the key "Mutual Fund" Facts document

As stated, there are no warnings on the document as to the importance of the document within the context of the contractual relationship between the advisor and client and no document defining the parameters of the service and relationship being offered. As such there is also nothing that requires the advisor to justify the recommendation, or anything that records the advisor's off the record comments.

What does the fund invest in?

The textual explanation is a shortened version of the information provided in the simplified prospectus. It is noted that there is no guidance on what needs to be provided in this small segment.

The top ten investments may provide a useful snapshot of the top 10 holdings but it does not provide the necessary perspective on the entire fund[5]. Likewise the sector allocation provided has little relevance unless the client can relate it to a benchmark[6]. It is also not clear what will happen with global market funds where market as well as sector allocation is important.

If you want to be able to correctly understand the benefits and risks of investing in a fund (or to be able to compare it to another) you need to understand the following at the very least.

1. Where the fund stands relative to the market (or other benchmark) in terms of sector, market cap, risk (standard deviation or other risk metric), valuation (P/E, P/B etc), yield and cost.

2. The risk, allocation and valuation profile of the portfolio and where and why the fund fits into the portfolio.

In the absence of the above requirements the relevance of the document towards acceptance of the suitability of the recommendation is severely constrained. Obviously, if an advisor is taking responsibility for the recommendation and the suitability of the strategy then this is an entirely different matter.

Without the ability to correctly assess the risk and asset allocation profile of a fund both in of itself and within a portfolio, it is impossible to correctly assess the benefits and risks of the investment, let alone being able to compare one fund with another.

How has the fund performed?

The warning over "It's important to note that this does not tell you how the fund will perform in the future" is an insufficient warning regarding the risks of buying an investment on past performance and does not convey the necessary information over the risks of relying on past performance. This warning is important given that there are likely to be other marketing and sales aids illustrating the performance of a fund.

However, what is more important than the performance is the portfolio rationale for including the investment in the first place. With a clear rationale and framework structured to manage the risk of the investment, the influence and consequence of performance on fund selection becomes less important. Again, we are forced back to suitability as being the most important determinant of a recommendation.

Also, the heading "average return" should read "historical average return". Average return alone could easily be construed as being an expected average return. It is here that the weak warning over relying on past performance may allow an investment to be sold on a strong average annual performance. There is nothing stopping an average annual return (over a period of above average return) from being compared against the

[5] The top 10 holdings provide information on the concentration of the portfolio.

[6] Does the client know the sector weightings of each market index and market index component (small, mid, large cap, value, growth)?

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current annual returns on lower risk cash and fixed interest investments and there are no warnings in this section to alert the investor over the risks of doing so.

There is also no comparative performance against an appropriate benchmark or a risk adjusted performance figure, important if the client is going to be held responsible for the recommendation and the resulting strategy.

Security selection and portfolio construction, whether the funds and securities are selected within an advisory or a discretionary service structure, is a complex area and one which the investment advisor and financial institution has considerable discretion. If investors are going to be assumed to have made the investment decisions themselves then they would need to have access to the information that would allow them to do that. This level of information is clearly insane and inappropriate for most investors and is why the vast majority of investors rely on their advisors and institutions to come up with the recommendation.

How risky is it?

The risk spectrum provided relates to the IFIC risk designations but the document makes no such reference and provides no explanation.

A moderate risk profile as noted by IFIC documentation[7] is equivalent to a 100% exposure to a major market index. A 100% equity allocation to any one market would be considered an aggressive investment stance within most retail portfolio construction methodologies. The IFIC risk spectrum also has a different structure to that implied by the risk profiles and investment objectives found on most client account agreement (KYC) risk assessment questionnaires.

The absence of an explanation of the meaning of the risk notation risks the advisor introducing their own, thereby contaminating the integrity of the communication. It is therefore important that the explanation of the document's risk communication conforms to the IFIC definitions as well as the risk assessment profile set within the client account agreement.

If an advisor is doing their job properly, the recommended fund's risk and asset allocation profile will be of greatest importance to the risk and asset allocation profile of the portfolio; we know that by including funds with low relative correlation risk (volatility) is reduced and return for a given level of risk enhanced. The focus on the particular risk of one fund to the exclusion of its impact on the risk and return profile of a portfolio is contrary to accepted financial theory and practise.

If you do not understand the impact of a fund's selection on the risk and asset allocation profile of the portfolio then you cannot make a selection. Again, this confirms the importance of the document as being no more than a sales aid and basic product introduction.

Are there any guarantees?

Presumably a specific section is included because of the discussion of guarantees on segregated funds.

Who is this fund suitable for?

As with the rest of this document there is little or no explanation of the rationale under pinning this section. In the simplified prospectuses offered by mutual fund companies it is noted that this section is meant as a general guide only and investors are asked to consult their advisors for advice appropriate to their own financial circumstances.

Why an investment is suitable for someone is complex. The size and timing of an investor's financial needs, their risk profile and investment objectives and the style and discipline provided by the advisor and the company will all contribute to which funds are selected and how much of each fund will be purchased. Until a

[7] IFIC Recommendations for Fund Volatility and Risk Classification September 2005

suitability decision process has been effected no investment can be considered suitable.

If an individual investor is initiating a transaction then the information regarding suitability might be of use as a warning. But it must be noted that the information regarding suitability in this document is at a very, very basic level.

The warning "Do not buy this fund if you need a steady source of income from your investment" is also confusing and assumes that a fund recommendation is a stand alone decision for a specific lump of capital with a clearly identifiable time frame and investment objective; something which you would need fairly sophisticated models to clearly delineate for each fund and capital allocation. A portfolio will need to balance both short and long term assets for a given set of financial objectives and risk preferences and will therefore be comprised of assets with varying degrees of risk and varying degrees of yield or income.

Many wealth management services promise much more than a stand alone transaction and this fund fact document is clearly at odds with the implied processes governing suitability within these services. We are therefore brought back again to the need for an account opening document that clearly defines the service that the client is contracting for and information on the process that an advisor and his or her firm use to determine suitability. These simple documents relate to the most base of transaction driven services and nothing more.

This section should also include a direction to the individual to confirm the rationale for the recommendation made by their advisor in the absence of such. Why do you recommend this fund, why is it suitable for me, why does it meet my risk preferences and investment objectives and how does it fit into the portfolio?

How much does it cost to buy?

There is nothing here that specifically asks the advisor to disclose the actual amount they are receiving or indeed any specifics with respect to trailer fees. There is also nothing about the importance of costs in determining total return to the investor. Few individuals are aware of the impact of transaction, annual management expenses and trailer fees on return. By reducing the amount of return and yield available from an asset class costs increase the amount of risk incurred.

Many asset classes can be accessed more cheaply and efficiently and no cost comparison is provided or alluded to in this document. Some advisors are limited to mutual funds or segregated funds while others can sell all including market traded securities; the importance of this is not noted in the document. The document is therefore focussed on higher cost managed investment vehicles, further reinforcing the reality that this document is a sales aid. If higher initial and annual costs are being incurred[8] these need to be justified not just at outset but over time[9]. With no regulatory requirement to provide a comparative risk and performance analysis there is no effective monitoring of the advice and recommendations provided to the investor post transaction. If a trailer fee is not designed to cover ongoing management of suitability and strategy, then what exactly is it designed to cover? These and many other questions are left unasked let alone unanswered.

There is nothing in the key facts that asks investors to question the costs and the impact of costs on risk and return. The information does not even allow an investor to compare the specific costs of different fund or security options given the regulatory constraints on who can sell and advise on a given product or security.

What if I change my mind?

Obviously the 2 day cooling off period is not a specific recommendation of the joint forum, but where does the rationale for a 2 two day cooling off period come from? A recommendation made in a well defined service supported by a well structured and communicated suitability process is unlikely to lead to a recommendation

[8] Relative to a lower cost alternative.

[9] A higher cost needs to have a demonstrable higher or relative value; lower risk, higher yield or a more specific focus style or asset allocation focus etc. There are clear rationales for both passive and active management and investors also need to pay for the costs of the advice and the service they are receiving, but these need to be detailed and justified.

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wholly inappropriate or unsuitable to the client. The risks for an inappropriate recommendation in the absence of such a framework are much higher. Armed with only a Key Fund Facts document the investor has limited information to base a decision to cancel the contract.

Fund facts & Key Facts Segregated funds

Most of the comments applicable to the mutual fund facts documentation apply to the segregated fund documents. The following represent comments specific to the segregated funds' documents including the Key Facts document.

The documents state that the "**contract comes with guarantees that protect your investment if the markets go down"**. In truth the contract does not protect the value of "your investment" if markets go down, it only guarantees the initial investment value of each unit held through the 10 year period at the end of the 10 year term.

The guarantee is also nominal and the real value of the guarantee at the end of the 10 year period will be significantly less for a given level of inflation. If investors are concerned about risk there are many other strategies that can manage risk and these are not discussed in the documentation. In truth there is no serious discussion over the suitability of these higher cost investments or the many alternatives available.

Simplified prospectus

Much of the information here is either generic to be specific to the recommended transaction or too complex for the individual investor to understand. The simplified prospectus generally provides no asset allocation or specific risk information and only deals with a fund on a fund by fund basis, not within a portfolio context. It is therefore understandable that a simple document that an investor will read should be available, but the proposed document is insufficient for the client to be able to take responsibility for the transaction.

Investor responsibility

Investors clearly need to be able to take responsibility for key investment decisions. Providing the investor with sufficient information to allow them to take responsibility for a course of action is important.

However, we must be clear as to what the investor is taking responsibility for and the framework that needs to exist to support this level of responsibility. The knowledge, expertise, resources, discipline and systems required to construct, plan and manage a portfolio of assets and securities to meet financial needs and risk preferences is far beyond the realms of the average advisor let alone the individual investor.

Most investors (and advisors) are dependent on a financial services company's resources, systems and expertise for the research, the selection, the valuation and the allocation of assets and securities. If an investor is provided with a) an explanation of the service they are receiving, the limitations, the costs and the responsibilities and b) an explanation and understanding of the process in which the suitability of the asset allocation and security selection is made, c) a risk assessment process appropriate to that process, d) an explanation of the rationale for the recommendations, why they are suitable and appropriate, the risks, the costs and e) basic information regarding the assets and securities provided then an investor will be in a position to accept the generic risk profile of the strategy and securities provided.

Conclusion

It is unclear just what the real objective of the Joint Forum's proposal is. Any attempt to improve knowledge and understanding of products at the point of sale is welcomed but the framework currently recommended is insufficient to allow "investors to have a basic and correct understanding of the potential benefits, risks and costs of investing in a fund and to be able to meaningfully compare one fund with another". Moreover the information provided is insufficient upon which to ascribe responsibility over the transaction decision to the client.

Sooner or later the regulatory structure is going to have to bite the bullet over the importance of advice and the processes governing the implementation of that advice in the form of suitable wealth management solutions. This bullet was clearly outlined in the Fair Dealing Model, a model whose core principles and astute observations appear to have been ignored in the preparation of this proposal.

As a final perspective on the key fund documents the following is an excerpt of a comment made by the UK Financial Services Authority and it is worth bearing in mind when weighing up the aims and objectives of the proposed key fund facts documentation.

"*Firms* are reminded that any *key features*, *simplified prospectus*[1] or other information …..is a form of *financial promotion*"[10][11].

[10] http://fsahandbook.info/FSA/html/handbook/COB/6/2

[11] Please also see the following links; http://fsahandbook.info/FSA/html/handbook/COB/6/2; http://www.fsa.gov.uk/pubs/consumer-research/crpr52.pdf

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