



# ASSESSING SUITABILITY WITH REGARD TO INVESTMENT ADVICE IN SOUTH AFRICA

An update on international developments pertaining to risk profiling and a critical analysis of FAIS Ombud determinations with regard to the suitability of investment advice, with specific reference to the risk profile of investors, and its potential impact on investment advice in South Africa

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# ASSESSING SUITABILITY WITH REGARD TO INVESTMENT ADVICE IN SOUTH AFRICA

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## Introduction

Risk profiling has been the subject of much debate for many years and after more than a decade since the publication of an article in the Journal of Law and Financial Management written by Tom Valentine, published by the University of Sydney in 2003, I would argue that not much has changed to assist financial planners to comply with their risk profiling obligations in terms of legislation.<sup>1</sup> Although it must be recognized that some industry stakeholders have introduced improved questionnaires and others have done in depth research to improve the outcomes of some of the components of risk profiling, the results from a 2015 survey show that financial advisors in South Africa are still using risk profiling questionnaires that are not fit for purpose. A number of service providers have conducted comprehensive research on risk tolerance in particular and provided tools to assist financial planners. Unfortunately, risk profiling is a much broader concept than risk tolerance and most questionnaires do not address the full spectrum of risk profiling. After many studies have been completed and after many good papers and articles have been published, the financial services industry internationally is still battling to find an industry standard for risk profiling that can be used by financial planners with total confidence.

It must be stated at the outset that this study is conducted from a deeply concerned financial planner's perspective. If risk profiling questionnaires are not fundamentally sound, it is instrumental to inappropriate advice, which ultimately is to the detriment of investors. This would defeat the objective of any legislation which prescribes suitability of advice to customers (investors). This is my primary concern. My secondary concern is the fact that many advisors unknowingly use flawed risk profiling questionnaires to comply with risk profiling requirements contained in legislation, which leads to a classic, flawed tick-box approach to compliance. Financial planners (advisors) are subject to extremely onerous fiduciary duties and regulatory obligations and when clients complain, the FAIS Ombud's Office critically analyses every risk profile questionnaire and if they are found to be flawed, the Ombud has no other option but to hold the advisor in question accountable. There are a number of examples where the questionnaires were found to be flawed and the Ombud found against the advisor.<sup>2</sup> If risk profiling is not properly researched and addressed in South Africa, financial planners will continue to offer inappropriate advice to investors and when clients complain, they will continue to be held fully accountable for the outcome.

<sup>1</sup> See section 16 of the Financial Advisory and Intermediary Services Act, 37 of 2002 and section 8(1)(c) of the FAIS General Code of Conduct

<sup>2</sup> See Gerald Edward Black v John Alexander Moore and Johnsure Investments CC, FAIS 0110-10/11 WC 1

In 2003 Valentine<sup>3</sup> argued in his paper that *the adviser should establish a risk profile for each client (sometimes this process is described as determining the client's risk tolerance, although these two objectives are slightly different) and to make recommendations in sympathy with this risk profile. This approach is strongly supported by the Financial Planning Association (FPA) and the Australian Securities and Investments Commission (ASIC) and it is seen as compliant with the "know your client" and "know your product" rules originating from Section 851 of the Corporations Law as it applied at the time.* He concluded that: *Current practice in the financial planning industry requires advisers to measure the risk profiles or risk tolerance of their clients. However, the meaning attached to these concepts is quite vague.* In 2016 some of these concepts are still quite vague.

The FSA Guidance Paper on the suitability of advice and the risk investors are willing and able to take was published in January 2011. Their findings sent warning signals to financial planners and it attracted the attention of Regulators internationally.<sup>4</sup> As stated in the previous paper,<sup>5</sup> South African stakeholders simply have to consider some of the following key findings contained in the 2011 FSA Report as most findings, if not all, apply to the SA market as well:

1. Many firms fail to take appropriate account of their clients' capacity for loss.<sup>6</sup>
2. They expressed concern that questionnaires use poor questions and answer options and have over-sensitive scoring or attribute inappropriate weighting to answers<sup>7</sup>
3. Flaws in questionnaires can lead to inappropriate conflation or interpretation of customer responses<sup>8</sup>
4. Many examples of descriptions have been found to be vague and do not effectively explain or differentiate levels of risk.<sup>9</sup>
5. Even where the risk profile has been correctly assessed, the product or portfolio does not always match this profile.<sup>10</sup>
6. Some firms unduly focus on the risk a customer is willing to take and fail to take sufficient account of the customer's needs, objectives and circumstances.<sup>11</sup>
7. Customer risk category descriptions are unclear or misleading.<sup>12</sup>
8. Descriptions or illustrations do not clearly quantify the level of risk.<sup>13</sup>
9. Description of the investment strategy is inconsistent with most customers' understanding of the risk posed by the category description, i.e. cautious.<sup>14</sup>

<sup>3</sup> Journal of Law and Financial Management, University of Sydney

<sup>4</sup> See the report by the Investor Advisory Panel, an independent committee of the Ontario Securities Commission in Canada

<sup>5</sup> See the Industry White Paper on Risk Profiling (2014), page 6 - 7

<sup>6</sup> FSA Report March 2011, page 3

<sup>7</sup> FSA Report March 2011, page 3

<sup>8</sup> FSA Report March 2011, page 3

<sup>9</sup> FSA Report March 2011, page 4

<sup>10</sup> FSA Report March 2011, page 4

<sup>11</sup> FSA Report March 2011, page 4

<sup>12</sup> FSA Report March 2011, page 16

<sup>13</sup> FSA Report March 2011, page 16

<sup>14</sup> FSA Report March 2011, page 16

The practice of risk profiling also caught the attention of the South African FAIS Ombud as their annual report in 2012 revealed that:

*The Ombud's office frequently encounters a disconnect between a complainant's risk tolerance, as calculated according to questions laid out in a risk profile document and the complainant's actual circumstances. Risk profile questionnaires can be interpreted in several ways and are not always specific or relevant to the investment at hand. Risk must be disclosed and in clear unambiguous language.*<sup>15</sup>

Subsequent to the FAIS Ombud's Report a group of industry professionals and selected academics came together on the 22<sup>nd</sup> of January 2014 and the 20<sup>th</sup> of June 2014 to discuss the challenges with regard to the disclosure of risk and the application of risk profiling questionnaires in South Africa. These discussions lead to constructive debates, which resulted in the release of the industry's first white paper on risk profiling in South Africa, released on the 26<sup>th</sup> of August 2014. Again, for their insight and constructive criticism the following individuals deserve much praise and thanks:

*Dr. Henco van Schalkwyk, Anthony Campher, Brian Foster, David Kop, Daniel Opperman, Dawn Julyan, Gavin Came, Gerda van der Linde, Germa Beukes, Gerrit Viljoen, Ian Hutton, Jessica (Green) Fannin, Justus van Pletzen, Kobus Barnard, Marius van der Merwe, Peter Strydom, Pierre de Klerk, Wessel Oosthuizen and Mr. Geoff Davey, Co-founder and Director of FinaMetrica.*

In June 2014 the topic of risk profiling was debated at the Financial Planning Institute (FPI) National Convention where the following were highlighted:

- The FAIS Ombud's Office has referred to the significance of the risk profile of investors in numerous of their published determinations since 2006
- A number of South African commentators on risk profiling have published their concerns relating to the use of fundamentally flawed questionnaires since the introduction of the Financial Advisory and Intermediary Services Act on 30 September 2004<sup>16</sup>
- The FSA Paper on suitability and risk profiling released in 2011 should be a warning sign of things to come in the financial services industry, because historically South Africa has followed many of the UK regulatory initiatives, such as Treating Customers Fairly (TCF), TWIN PEAKS and Retail Distribution Review (RDR)
- The following reports were referred to in support of the importance of risk profiling as part of the process of providing suitable advice to investors:
  - The Society of Actuaries in Ireland - 2011
  - FinaMetrica Paper [SA Version] – 2012
  - CONSOB Discussion Paper – July 2012
  - FAIS Ombud Report – October 2012
  - DNA Behavior International – May 2013
- It was recorded during the panel discussion that, in view of all the local and international reports and the scrutiny by international regulators, financial advisors should expect the Financial Services Board to intervene in South Africa in the near future. It was proposed that members of professional and industry bodies be proactive, review their questionnaires and not to wait for any regulatory intervention.

<sup>15</sup> As reported in Money Marketing (SA) Article dated 31 December 2012

<sup>16</sup> See Swanepoel, Risk profile questionnaires: Inappropriate questions lead to inappropriate advice, FSB Bulletin, First quarter 2007, p 12-15

In March 2015, the *Profile's Unit Trusts & Collective Investments Handbook* gave the following recognition in its foreword by the editor to the concerns raised in the Industry White Paper on Risk profiling:

*This, the 38<sup>th</sup> edition of Profile's Unit Trusts & Collective Investments marks a renewed focus on risk and risk assessment. This has been triggered, at least in part, by a white paper circulating in the industry on the subject of risk profiling. The white paper highlights some of the very real problems that exist in the construction and use of risk profiling tools. In keeping with the white paper initiative we have deemed it an appropriate time to refine and update the questionnaire by separating risk capacity and risk appetite questions. Chapter 6 now includes two questionnaires that work together to give a fuller picture of an individual's risk profile. Quantifying and communicating the risks inherent in different funds and sectors is an industry challenge that is yet to be solved. As the white paper points out volatility (the standard deviation of returns) has certain limitations: it is intuitive and it positively misrepresents riskiness under certain market conditions...*

In September 2015 the Financial Intermediaries Association of South Africa (FIA) hosted a national road show during which two hundred and thirty seven (237) advisors, who are licensed to provide investment advice, participated in a risk profiling survey. In October and November 2015, three hundred and seventeen (317) members of the Financial Planning Institute of Southern Africa, who are licensed to provide investment advice participated in the same survey, which were conducted during the annual Refresher courses around the country.

The survey revealed that more than 85% of all five hundred and fifty four (554) advisors that participated expressed the opinion that risk profiling questionnaires currently used in the financial services industry in South Africa are *insufficient* to provide appropriate advice to investors. International reports refer to this as risk profiling tools being “not fit for purpose”. These results should be a primary concern for all the industry stakeholders and if these concerns are not addressed the two stakeholders that are most at risk are:

➤ **Investors**

Logically, if the majority of risk profiling questionnaires are insufficient to assist advisors to provide appropriate advice, investors would be receiving inappropriate advice from those advisors using them, which could defeat one of the primary objectives of the FAIS Act and its subordinate legislation.

➤ **Financial services providers**

Financial services providers (firms) and their representatives (financial planners or advisors) that use insufficient tools that leads to inappropriate advice are responsible for the outcomes under the Act and they are being held accountable by the FAIS Ombud. In terms of the FAIS Act financial services providers, their key individuals (those responsible for the management and overseeing of those who provide advice) and their representatives (the financial planners or advisors who provide advice) are co-responsible<sup>17</sup> for the suitability of advice they provide to investors and if they should use fundamentally flawed risk profiling questionnaires that are instrumental to inappropriate advice, they have been, and will continue to be, held accountable for the outcomes. In all of the FAIS Ombud determinations the individual advisor concerned (the representative) and the FSP concerned (the firm and in some cases the firm's key individuals in their personal capacity<sup>18</sup>) have been held accountable in cases where the Ombud found in favour of the complainant.

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<sup>17</sup> See John Alexander Moore and Johnsure Investments CC v Gerald Edward Black Appeal Board Decision FAIS 0110-10/11 WC 1

<sup>18</sup> See John Alexander Moore and Johnsure Investments CC v Gerald Edward Black Appeal Board Decision FAIS 0110-10/11 WC 1 and Paul James Joseph Rauch and Jacob Johannes van Zyl and Hendrik Christoffel Lamprecht FAIS 02381/09-10/GP 1

Of all the stakeholders, financial services providers, including their representatives (advisors and intermediaries), are the only parties that attract advice risk to their business in terms of the FAIS Act. In the event of a client complaint, financial services providers carry an *onus of rebuttal* after a complaint is lodged, which means that they have to prove that they complied with the provisions of the FAIS Act and with the provisions of the General Code of Conduct in particular. The use of fundamentally flawed questionnaires, which lead to inappropriate advice, by definition is an act of non-compliance and will undoubtedly lead to determinations against providers. This is evident from the published determinations.

As this paper will show, the FIA and FPI member survey results provide some explanation as to why the FAIS Ombud expressed their concern, and in my opinion quite rightly so, about these risk profiling questionnaires that are currently being used by the majority of advisors in South Africa. Financial services providers that do not take these observations by the FAIS Ombud seriously will only have themselves to blame if future Ombud determinations go against them. The FAIS Ombud has already ruled that, if-

- advisors do not carry out any analysis to ensure that the proposed product was suitable for the client, bearing in mind the latter's needs and financial risk profile, they will be in breach of Section 8 of the Code;<sup>19</sup> and
- the entire exercise of going through the risk analysis is a mere formality performed to comply with the formal requirements of the FAIS Act and there is no analysis of the results and what the implications of investing in high risk products entail, it would constitute a breach of the Code of Conduct.<sup>20</sup>

### ***Recent international research***

In March, 2015, PlanPlus Inc., an independent company was engaged by the Investor Advisory Panel in Canada to perform research into the current practices in the Canadian marketplace that are used to determine a client's risk profile and to evaluate these practices compared to best practices globally. The research focused on the practices of investment advisors and firms, including those licensed and operating under the Mutual Fund Dealers Association of Canada (MFDA), the Investment Industry Regulatory Organization of Canada (IIROC) and portfolio managers (PMs).

On 12 November 2015 the Investor Advisory Panel, an independent committee of the Ontario Securities Commission, published their report titled: ***Current Practices for Risk Profiling in Canada and Review of Global Best Practices***

This independent research was prepared by Shawn Brayman, President of PlanPlus Inc., along with co-authors Dr Michael Finke, Texas Tech University; Ellen Bessner, Babin Bessner Spry LLP; Dr John E. Grable, University of Georgia; and Dr Paul Griffin, Humber Institute of Technology and Advanced Learning. What follows is an extract of the media release on the 12<sup>th</sup> of November 2015:

*This report is a summary of the outcomes of that research which is comprised of: an academic literature review; a regulatory review that included Canadian and international regulators; a review of current solution providers; and a review and analysis of current practices in Canada. The latter included a survey of investment advisors' use of a standard risk assessment questionnaire (responses were received from 338 advisors); a similar survey of firms and their compliance departments; and an analysis of 36 risk profiling questionnaires currently in use by a variety of firms in various sectors of the industry.*

<sup>19</sup> Elizabeth Maria Catharina Van Schalkwyk v Investiplan (PTY) Ltd (and another) FAIS 04143/12-13/GP 1 (page 10 par 33.5); Natalina Natali v Impact Financial Consultants CC (and another) FAIS 04032/12-13/WC1 (page 3 par 4.4)

<sup>20</sup> Ethel Ellouise Blessie (and others) v Shevgem Investments CC t/a Randsure Brokers (and other) 02202/09-10/KZN/1 (page 14 par 46)

*Risk profiling is a complex, multi-dimensional process that combines many factors, both subjective and objective, to create a 'risk profile' - an overall assessment of the most appropriate level of risk for a consumer/investor. The research found overwhelming evidence that the issue of assessing a client's risk profile and recommending suitable solutions is a primary area of concern in the industry. Every regulator interviewed as part of this project rated determining a client's risk profile as being of "high importance". The research found:*

- 1. There is a confusing and universal lack of existence or consistency of the definitions of risk concepts and a lack of understanding of the factors involved in risk profiling.*
- 2. Almost all regulators surveyed are principles-based and provide little guidance on how a firm or advisor should arrive at the determination of a risk profile.*
- 3. They all recognize and rely on the professional judgment of the advisor and the 'process' created by the advisor or firm to determine a consumer's risk profile.*
- 4. No regulator provides clear guidance on how to combine the multiple factors and form a client risk profile.*
- 5. Risk questionnaires are most widely used in retail channels using mutual funds and less so in wealth management and portfolio manager channels.*
- 6. Over 53% of respondents to the advisor survey indicated that between 76-100% of their clients had completed a risk questionnaire.*
- 7. Almost half of the firms reported that risk questionnaires were developed in-house and another 36% said that advisors could choose their own risk profiling methodology.*
- 8. Only 11% of firms could confirm that their questionnaires were 'validated' in some way.*
- 9. Most of the questionnaires (83.3%) in use by the industry are not fit for purpose - they have too few questions, poorly worded or confusing questions, arbitrary scoring models, merge multiple factors (75%) without clarity or have outright poor scoring models.*
- 10. Fifty five percent had no mechanism to recognize risk-averse clients that should remain only in cash.*

*The research report offers examples of best practices in other jurisdictions and concludes with recommendations for regulators, industry and the academic community.*

*"Risk profile assessment is key to a successful Know Your Client (KYC) Suitability process", said Ursula Menke, Chair of the Investor Advisory Panel. " We have asked the OSC's Investor Office to coordinate with PlanPlus Inc. to offer briefings on the research findings to members of the Canadian regulatory community and to industry members and representatives to ensure that these findings are well known and understood. The IAP hopes that regulators and industry participants will use the information in the report to build better, more robust client risk profiling systems."*

In view of the aforementioned developments and research it should be very clear to all the stakeholders in the financial services industry, but to providers of financial advisory services (firms and their representatives) who are licenced to provide investment advice to investors in particular, that providing suitable advice to investors has attracted the attention of regulators globally.

One of the factors that should grab the attention of industry participants is the high correlation between the finding in Canada, that 83.3% of the risk profiling questionnaires in use by the industry are "not fit for purpose", and that more than 85% of advisors believe that current risk profiling questionnaires in South Africa are insufficient to provide suitable advice.

If the FSA Report from the UK, the OSC Report from Canada and the research results from the financial planning industry in South Africa are any indication, there seems to be overwhelming evidence that risk profiling is still an international dilemma, which should be of primary concern to those who provide advice to investors.

The fact that National Treasury in South Africa is currently busy with its comprehensive regulatory reform process and establishing the TWIN PEAKS model in South Africa, is probably one of the main reasons why the Financial Services Board of South Africa has not yet followed the Financial Conduct Authority in the UK to conduct an investigation into the current risk profiling practices. Hopefully this paper will create awareness of the significance of the problem and inspire financial services providers to review their advice processes and questionnaires to ensure that they serve the best interests of their clients.

### **Disclaimer:**

Whilst the fundamentals of risk profiling applies to all financial planners internationally, this paper should be read in the context of financial planning in South Africa. Although the author must acknowledge the significant contribution of PlanPlus Inc., academia, regulators, financial advisors and the Office of the FAIS Ombud as referenced in this paper, the collective material contained in the legislation, all the published papers and articles, and the recommendations by all the parties are absolutely overwhelming. Financial planners will find it extremely difficult, if not impossible to consider, discuss, agree and implement all the elements contained in all these published works because of one reason, namely the behaviour of investors.

From 15 years of experience as a financial planner, hundreds of advisor workshops since 2002 and many individual discussions with astute and experienced professional financial advisors, all agree that financial planners do not have the luxury of addressing all the risk profiling components in detail, as proposed by some of the industry stakeholders and authors. As a rule, due to their own time constraints and personal preferences, retail investors do not generally make themselves available for long periods of time to be fully educated on investments and then make informed decisions.

In most cases financial planners and advisors have limited time to comply with all the regulatory requirements due to sometimes serious time constraints imposed by the very people the law is trying to protect and the people financial planners are trying to serve. The fact that investors contribute to some of the limitations that are imposed on financial planners is one aspect that is seldom, if ever, considered by the Regulator and the FAIS Ombud. As a result, it should be recognised that financial planners have the enormous task of absorbing all the challenges in the client engagement process, the deficiencies in risk profiling questionnaires and the strict interpretation of compliance with the provisions of the Act by the Regulator and the FAIS Ombud. In view of these harsh realities, I believe that part of the practical solution lies in applying the Pareto principle to risk profiling, which means that the industry needs to distinguish between the vital few and the trivial many. When it comes to risk profiling financial planners will have to distinguish between the *essential components*, the “good to know” components and the “nice to know” components. This paper focusses on the 20% essential risk profiling components that should assist clients in making informed decisions whilst protecting financial planners against client complaints in at least 80% of the cases.

This paper should therefore not be compared to a typical academic paper, some of which are referred to in this document, simply because some academic papers, although brilliant, do not explain the concepts in plain and simple language and are far too complex and technical to include in a discussion with clients, given the constraints imposed by investors. The intention is to highlight the need for, and the fundamentals of, *a practical risk profiling solution*, given the limitations imposed by investors as highlighted above, which will benefit investors and protect financial planners from a compliance point of view at the same time.

### The purpose of this paper is to:

1. define *suitable advice* to investors;
2. highlight the regulatory requirements pertaining to suitability in the South African market, with specific reference to investment advice;
3. explain the regulatory requirements pertaining to suitability in simple and clear language;
4. highlight the traditional approach of providing investment advice, which currently still forms part of the investment advice process of some of the more prominent financial services providers in South Africa, and identify the fundamental flaws that exist in that process;
5. highlight the importance for financial services providers to take note of, and learn from FAIS Ombud determinations to prevent the same mistakes;
6. identify those key sections in the FAIS General Code of Conduct and the most common omissions or acts by financial services providers (advisors) that the Ombud of Financial Services Providers (FAIS Ombud) refer to in their determinations, which constitute non-compliance with the provisions of the **Financial Advisory and Intermediary Services Act** and its subordinate legislation;
7. give an explanation why, as the FAIS Ombud stated: *“The Ombud’s office frequently encounters a disconnect between a complainant’s risk tolerance, as calculated according to questions laid out in a risk profile document and the complainant’s actual circumstances;”<sup>21</sup>*
8. explain why, as the FAIS Ombud stated: *“Risk profile questionnaires can be interpreted in several ways and are not always specific or relevant to the investment at hand;”<sup>22</sup>*
9. recommend how, as the FAIS Ombud stated: *“Risk must be disclosed and in clear unambiguous language;”<sup>23</sup>*
10. establish whether there is a common trend in the client interaction and advice process that eventually lead to client complaints, which could potentially lead to better pre-emptive measures by providers;
11. highlight the differences between the interpretation of risk, with particular reference to the interpretation of risk by the FAIS Ombud;
12. propose a definition of risk from an investment advice perspective, in view of the interpretation of risk by the FAIS Ombud;
13. identify possible unintended consequences for advisors and investors in view of the interpretation of “risk profile” by the FAIS Ombud;
14. establish a sound, fundamental framework for suitability of advice in respect of investments and investment products;

<sup>21</sup> FAIS Ombud’s Annual Report of October 2012

<sup>22</sup> FAIS Ombud’s Annual Report of October 2012

<sup>23</sup> FAIS Ombud’s Annual Report of October 2012

15. identify the critical components of an investor's risk profile;
16. submit proposals as to how providers can ensure that they have considered all those components in the advice process;
17. propose a sound framework for the type of evidence that should be acceptable to the FAIS Ombud when trying to resolve complaints related to the suitability of investment advice; and
18. submit proposals to the financial services industry to serve the best interests of investors, first and foremost, and to be more proactive in view of the risk profiling developments internationally, before the Regulator is forced to introduce further rules and regulations.

## 1. The definition of suitable advice to investors

According to the Oxford Advanced Learner's Dictionary *suitable* means (to do something) right or appropriate for a particular purpose or occasion.<sup>24</sup> Synonyms for suitable are appropriate, right, fitting and proper. Appropriate means suitable, acceptable or correct for the particular circumstances.<sup>25</sup>

In terms of the FAIS Act *advice* means, subject to subsection (3)(a), any recommendation, guidance or proposal of a financial nature furnished, by any means or medium, to any client or group of clients -

- (a) in respect of the purchase of any financial product; or
- (b) in respect of the investment in any financial product; or
- (c) on the conclusion of any other transaction, including a loan or cession, aimed at the incurring of any liability or the acquisition of any right or benefit in respect of any financial product; or
- (d) on the variation of any term or condition applying to a financial product, on the replacement of any such product, or on the termination of any purchase of or investment in any such product, and irrespective of whether or not such advice -
  - (i) is furnished in the course of or incidental to financial planning in connection with the affairs of the client; or
  - (ii) results in any such purchase, investment, transaction, variation, replacement or termination, as the case may be, being effected.

In terms of the aforementioned definitions, *suitable advice* to investors simply means to provide *appropriate* (right, correct and proper) *recommendations*, give appropriate *guidance* or make appropriate *proposals* to investors in their circumstances for a particular purpose. It is a simple concept, but considering all the money that have been lost by investors over the years, it is clear that the financial services industry still has a long way to go to fulfil this obligation to its customers. For this reason regulators internationally deem it necessary to incorporate *suitability* of advice as a regulatory requirement.<sup>26</sup>

A study of all the FAIS Ombud cases analysed showed that there is a striking similarity between South Africa and Canada as the statistics from both countries confirm that the most frequent matters of complaints and prosecution relate to *suitability*.<sup>27</sup> This finding should send a strong message to the Regulator and financial advisors in South Africa in particular, but I have a strong suspicion that these statistics are indicative of a worldwide trend. These statistics alone should support the importance of this paper.

<sup>24</sup> Oxford Advanced Learner's Dictionary, Oxford University Press 2005, p 1480

<sup>25</sup> Oxford Advanced Learner's Dictionary, Oxford University Press 2005, p 61

<sup>26</sup> See sections 8 of the FAIS General Code of Conduct (SA), 961G of Division 2 of Part 7.7A of the Corporations Act 2001 (Cth) as contained in the FoFA Guidance paper for CPA Australia public practitioners (July 2013), Financial Industry Regulatory Authority (FINRA) Rule 2111 (2014) U and the Financial Advisors Act of Singapore (MAS, 2012, page 20)

<sup>27</sup> See Investment Industry Regulatory Organization of Canada (IIROC) statistics (2014), page 22

## 2. The regulatory requirements pertaining to suitability, with specific reference to investment advice

According to the Financial Advisory and Intermediary Services Act, financial services providers (providers) must provide appropriate advice to clients. The FAIS General Code of Conduct (the Code of Conduct) prescribes that suitability of advice is a regulatory requirement and it also offers further general guidelines to assist providers when they provide investment advice to their clients. Section 8 of the Code prescribes that:

- (1) A provider... must, prior to providing a client with advice-
  - (a) *take reasonable steps to seek from the client appropriate and available information regarding the client's financial situation, financial product experience and objectives to enable the provider to provide the client with appropriate advice;*
  - (b) *conduct an analysis, for purposes of the advice, based on the information obtained;*
  - (c) *identify the financial product or products that will be appropriate to the client's risk profile and financial needs, subject to the limitations imposed on the provider under the Act or any contractual arrangement.*

The aforementioned provisions contained in the Code of Conduct offer very basic, broad, but sound guidelines as to what the suitability requirements are. A comprehensive study of FAIS Ombud determinations in respect of investment related complaints show that the Office of the FAIS Ombud consistently apply these provisions when investigating and resolving complaints. These provisions are consistently referred to by the Ombud when explaining their determinations against providers and it is for this reason that everything in this paper revolve around these provisions.

However, according to the Investor Advisory Panel almost all regulators surveyed internationally are principles-based and provide little guidance on how a firm or advisor should arrive at the determination of a *risk profile*.<sup>28</sup> The South African regulator is no different. They also recognise and rely on the professional judgment of the advisor and the 'process' created by the advisor or provider to determine a consumer's risk profile. Unfortunately, the lack of sound fundamental guidelines are instrumental to the fact that financial services providers will only know if their process, questionnaires or documentation are validated or not when they are actually faced with a client complaint and required by the FAIS Ombud to respond to such a complaint. It is only at this point that most providers' risk profiling questionnaires are scrutinised, critically evaluated and found to be flawed.<sup>29</sup>

According to the FIA and FPI survey results, there is a lack of confidence in the appropriateness of the majority of risk profiling questionnaires and it appears that they are just following a tick-box approach to suitability. Providers expressed the need to be confident that their risk profiling process is well-researched, fundamentally sound and that it provides the necessary evidence that can stand up against any scrutiny by the FAIS Ombud's Office.

<sup>28</sup> See the media release published by the Advisor Advisory Panel

<sup>29</sup> See *Gerald Edward Black v John Alexander Moore and Johnsure Investments CC FAIS 0110-10/11 WC 1*

From a study of more than thirty FAIS Ombud's determinations it is clear that the Ombud critically analyses each and every risk profile questionnaire to determine whether the provider complies with the provisions of the Code of Conduct. From a suitability point of view the Ombud always refer to the provider's duty to do a needs analysis in accordance with section 8(1)(a) of the Code and the Ombud's Office always look for evidence that prove that such an analysis was indeed performed. In the absence of such evidence, it constitutes a breach of the Code and if this breach was instrumental to providing inappropriate advice to the complainant and he or she suffered a financial loss as a result, the Ombud normally finds against the advisor.<sup>30</sup>

These determinations frequently refer to the provisions of section 8(1)(c) of the Code, which specifically require that the provider identify the financial product or products that will be appropriate to the client's risk profile and financial needs.<sup>31</sup> The FAIS Ombud's Office always pose the same fundamental questions to providers when investigating client complaints in terms of section 27(4) of the Act. These questions include:

1. Please explain on what basis did you deem the investment product to be a suitable investment for your client?
2. Please provide details of the due diligence you conducted, (if any); and
3. What actually led you to conclude that the risk inherent in the product was suitable to your client's risk tolerance?<sup>32</sup>

Analysis of the questions:

The first question relates to suitability in the broad sense, which include the provisions contained in sections 2, 8(1)(a), (b) and (c) of the Code of Conduct

It is of vital importance for all financial planners to realise that understanding the client's needs and establishing the client's risk profile correctly is fundamental to providing sound investment advice. Financial planners that do not take the provisions of section 8(1)(a), (b) and (c) extremely seriously, may find themselves totally exposed when facing a client complaint.

The results contained in the FAIS Ombud's report of 2012 as highlighted in the introduction of this paper confirm this finding.

### **3. The meaning of the regulatory requirements pertaining to suitability in simple and clear unambiguous language**

It is important for providers to understand that, when providing advice, the provisions contained in section 8 of the General Code of Conduct are not optional. To explain the meaning of section 8(1)(a), (b) and (c) in plain and simple terms the analogy between the duties of a medical doctor and that of a financial advisor may be helpful.

<sup>30</sup> See *Craig Steward Inch v Impact Financial Consultants*, FAIS 04971-12/13-MP 1, page 8, par 26

<sup>31</sup> See *Craig Steward Inch v Impact Financial Consultants*, FAIS 04971-12/13-MP 1, page 9, par 27

<sup>32</sup> See *Craig Steward Inch v Impact Financial Consultants*, FAIS 04971-12/13-MP 1, page 22, par 74

When ill, surely one would expect that the doctor will perform a proper diagnosis in order to understand the patient's medical condition, apply his mind with care, skill and diligence and with the patient's best interests in mind and then make a suitable recommendation which will solve the problem? Surely investors will not ask for investment advice if they do not have the confidence that the financial advisor concerned will do a proper diagnosis of their circumstances and objectives, apply his or her mind with due care, skill and diligence, with the client's best interests in mind and then offer appropriate products to achieve the desired outcome. Just as a medical doctor is expected to prescribe appropriate medicine to a patient, offering suitable advice and recommending appropriate financial products to investors are arguably the essence of what any financial advisor should master and apply in the best interest of their clients.

According to the FAIS General Code of Conduct, acting in the best interest of clients is a basic regulatory requirement and it is further enhanced by the FPI Code of Ethics and Practice Standards (2015), which highlights *Clients first* as its first principle.

To understand the client's current financial position as prescribed in section 8(1)(a) of the Code of Conduct, implies that both qualitative and quantitative information is required. From a quantitative point of view it means that an advisor should determine as a bare minimum, how much money the client has to invest, how much debt the client has, how much money the client has in the form of an emergency fund and how much money the client would require from an income point of view. Qualitative information refers to personal circumstances, such as family history, marital status, number of dependents, retirement plans etc.

Without an understanding of the client's personal and financial circumstances an advisor would have limited insight into the circumstances of the investor and as a result, the appropriateness of the advice may have its limitations as well. However, it must be recognised that not all clients are fully transparent when it comes to sharing information and it is for this reason that the General Code of Conduct requires that providers must take *reasonable* steps to seek from the client appropriate and available information.

According to section 8(1)(b) of the Code of Conduct the next step is to *conduct an analysis*, which according to South Africa's first FAIS Ombud, the late Charles Pillai, simply means *to apply your mind*.<sup>33</sup> It is during this process that the provisions of section 2 of the Code of Conduct provide important guidelines for advisors as it states:

*A provider must at all times render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry.*

Again the client is at the centre of everything. It will become clear later in this paper why these guidelines are so vitally important for every advisor who renders investment advice to clients. It should be clear at this point however that, the regulator clearly requires that financial advisors must do a proper diagnosis of their clients' financial circumstances and objectives, then apply their minds with due skill, care and diligence and in this process always act in the interests of their clients.

The provisions contained in section 8(1)(c) of the Code of Conduct, as specifically highlighted below, requires special consideration. It states that providers must-

- (c) *identify the financial product or products that will be appropriate to the client's risk profile and financial needs, subject to the limitations imposed on the provider under the Act or any contractual arrangement.*

It is of fundamental importance to note that *appropriate* refers to *two* aspects, namely the *client's risk profile and financial needs*. Nowhere in this provision does it imply that the one is more important than the other. The wording suggests that both these aspects have to be carefully considered before making any recommendation in respect of a financial product. *The two objectives in this framework, risk and return, are interdependent- one cannot be discussed without reference to the other.*<sup>34</sup> The risk objective limits how high the investor can set the return objective. In most cases it comes down to a trade-off between the two and in order to do that, one must understand the meaning of these terms.

### **Financial needs**

*Financial needs* is a term that has not been defined in the Financial Advisory and Intermediary Services Act and as a result the normal meaning of the words must be used in its application. Financial means *connected with money and finance*<sup>35</sup> and need means *to require something because (it)*<sup>36</sup> *is essential or very important, not just because you would like to have (it).*<sup>37</sup> Based on the statistics pertaining to the low percentage (close to 3%) of people in South Africa that can afford to retire, the majority of investors need to outperform inflation consistently over their investment term. They simply cannot afford not to do so, because the purchasing power of their capital would decrease annually and as a result investors would become poorer in real terms.

### **Risk profile**

The term *risk profile* has not been defined in the Act and therefore the normal meaning of the words must be used in its application under the FAIS Act. *Risk* means the possibility of something bad happening at some time in the future or a situation that could be dangerous or have a bad result.<sup>38</sup> To risk something is to do something even though the result could be unpleasant.

According to the Profile's Unit Trusts & Collective Investments (2006) Handbook, the collective investment schemes industry tends to simplify risk profiles into risk profiles into three main categories: Aggressive, balanced (moderate) and conservative.<sup>39</sup> Unfortunately, none of these terms are defined or quantified. The September 2006 edition of Profile's Unit Trusts & Collective Investments Handbook highlighted that the risk spectrum of funds were categorised into Low risk, Medium risk and High risk.<sup>40</sup> There is no definition of risk and no one answer to the problem of managing risk.<sup>41</sup>

In March 2009, during a risk profiling workshop I conducted a survey to establish what 25 top investment advisors think about its fundamentals. The survey showed that all providers that took part had extensive experience in advising investors who require capital growth and income from their portfolios. These providers therefore have an understanding of both income and capital growth needs and objectives of their clients. Only a sound understanding of the risks and the ability to determine the risk profile of clients will enable providers to offer appropriate solutions as required in terms of the General Code of Conduct. Of all the participants 73% defined risk as:

- ✓ Losing capital in nominal terms; or
- ✓ Losing capital in real terms over a certain investment period

<sup>34</sup> See Magin, Tuttle, Pinto and McLeavey, *Managing Investment Portfolios*, 3<sup>rd</sup> Edition, John Wiley & Sons Inc., p 11

<sup>35</sup> Oxford Advanced Learner's Dictionary, p 551

<sup>36</sup> My insert

<sup>37</sup> Oxford Advanced Learner's Dictionary, p 979

<sup>38</sup> Oxford Advanced Learner's Dictionary, p 1264

<sup>39</sup> See Profile's Unit Trusts & Collective Investments Handbook, Profile Media 2006, p 95

<sup>40</sup> See Profile's Unit Trusts & Collective Investments Handbook, Profile Media 2006, p 46

<sup>41</sup> Profile's Unit Trusts & Collective Investments (2015) Handbook, page 96

At the time more than 80% of these participants agreed that risk should be defined as *the risk of losing capital*. This is consistent with the meaning of the word as defined in the dictionary<sup>42</sup> and years later, an analysis of all the Ombud determinations have made it clear that the “*something bad*” that happened to investors, which initiated all of their complaints, was that they all *lost money*. To risk something is to do something even though the result could be unpleasant.<sup>43</sup> Nobody would argue that losing money is unpleasant. A common trend throughout all FAIS Ombud complaints and ultimately Ombud determinations is the loss of capital or financial loss and its negative effects on clients, both financially and emotionally. *Profile* is a description of something that gives useful or important information.<sup>44</sup> A person’s profile may also be defined as a character sketch.

In view of the aforementioned definitions, I would argue that most people’s real risk profiles only become clear *after* they have lost money. Losing money reveals the true character of a client. To avoid any nasty surprises for both advisor and investor, it is extremely important to do everything reasonably possible to establish an investor’s risk appetite or tolerance (acceptance) before any investment is made. Without an understanding of the client’s “chance or possibility of loss” tolerance or acceptance level, it is argued that it would be impossible for any investor to make an informed investment decision as prescribed in the FAIS Act.<sup>45</sup>

#### ***A practical example***

A person may need R 10 000 per month after tax to pay for a roof over his head and feed his family and this may well be essential or very important. However, an investment of R 800 000 may not be enough to sustain this need over the life expectancy of the investor. To achieve this outcome it may be required to invest in a financial product that offers a high return, but as we have learned higher returns are normally associated with taking on bigger risks (chance of loss). It is for this reason, I believe, that the General Code of Conduct quite correctly measures appropriateness of the financial product in accordance with the financial needs *and* the client’s risk profile – not only the one or the other. This means that the advisor will have to carefully consider *both* aspects before recommending a financial product.

#### ***The problem***

Many complaints are submitted by elderly and/or retired investors.<sup>46</sup> As highlighted earlier, statistics show that only approximately 3% of South Africans are financially in a position to retire. This implies that more than 97% of people who want to retire are not in a position to do so. They simply do not have sufficient retirement capital to meet their income needs over their life expectancy. Based on their capital provision their financial *needs* at retirement may therefore be unrealistic. This category of client normally requires an unrealistic investment return on capital to meet his/her income needs. This implies that often, out of desperation, when they make investment decisions they base it on higher, unrealistic and unsustainable investment returns. Often, in desperate situations investors are drawn to investment products that offer higher returns than those products that would better suit their risk profile. There is a clear trend in the determinations in that, whilst decisions to invest are often made based on expected returns, when these investors lose money, their focus turn to the risk, which then poses an advice risk problem for the advisor. This is only one of a number of practical challenges for advisors when they provide advice to investors under the Act.

<sup>42</sup> See Swanepoel, FSB Bulletin, Second Quarter, p 4

<sup>43</sup> See Oxford Advanced Learner’s Dictionary: p. 1264

<sup>44</sup> See Oxford Advanced Learner’s Dictionary: p. 1160

<sup>45</sup> See sections 7(1)(a) and 8(2) of the General Code of Conduct

<sup>46</sup> See Gerald Edward Black v John Alexander Moore and Johnsure Investments CC FAIS 0110-10/11 WC 1

#### 4. The traditional approach of providing investment advice, which currently still forms part of the investment advice process of some financial services providers, and the fundamental flaws that exist in the process

During the FIA road shows I tested the opinion of hundreds of advisors, based on their experience of what is happening in the industry. They have all agreed that many, if not most, of the financial services providers and product suppliers would prescribe the following client interaction process to its representatives and its independent advisor supporters:

##### 4.1 Meet the client

##### 4.2 Gather client information

##### 4.3 Complete a client risk profile questionnaire

4.4 If, according to the risk profile questionnaire, the client is conservative, moderate or aggressive, the advisor recommends a conservative, moderate or aggressive investment portfolio as constructed by the product supplier

4.5 Complete the paperwork, submit the proposal and ensure that the money is paid over to the product supplier into the recommended portfolio

4.6 If advisors follow this process, they ticked all the boxes and are deemed to be compliant, but there are a number of flaws in this so-called “compliant” process. For example:

4.6.1 As already stated, more than 85% of advisors in South Africa believe that the risk profiling process in South Africa is flawed and according to the Investor Advisory Panel, the independent committee of the Ontario Securities Commission, most of the questionnaires (83.3%) in use by the industry are not fit for purpose.

4.6.2 One of the problems with the traditional method used is that it has very little to do with meeting the client’s objectives. This approach therefore does not meet the requirement in terms of section 8(1)(c), which states that the advisor must seek appropriate product(s) in accordance with the client’s risk profile *and needs*.

4.6.3 This process allows the client’s risk profile, mostly referring to risk tolerance (which is subjective), to drive the process instead of finding a balance between subjective feelings and objective advice in order to achieve the client’s objective. If the advisor invests the client’s money according to his/her “conservative” risk profile, neither the advisor nor the client would know whether the investment will meet the client’s needs and/or objective(s) as required in terms of sections 8(1)(a) and 8(1)(c) of the Code of Conduct. This can be compared to a patient with little or no experience doing a self-diagnosis and selects his/her own medicine through a default, automated process and the doctor has no other choice but to rubberstamp the decision.

4.6.4 During the FIA roadshow sessions late in 2015 advisors generally agreed that, in their experience, investment markets do tend to influence investors’ perception of risk. In bull markets investors tend to be more “aggressive” and in bear markets investors tend to be more “conservative”. Investor perception leads to inappropriate asset allocation in the different market conditions.

Warren Buffett, arguably one of the world's most successful investors, does exactly the opposite as he famously quoted: *We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful.*<sup>47</sup>

- 4.6.5 In short, traditional risk profiling is a classic case of keeping *good records* of *bad advice* and it is instrumental to inappropriate advice and therefore non-compliant, which leaves the advisor (representative) and the firm (financial services provider) exposed when a client should complain. This is not only a South African problem as advisors in other countries have also expressed their surprise that our industry is still using outdated risk profiling techniques.<sup>48</sup>

***This begs the question:***

Is the financial services industry in South Africa going to rectify these flaws that currently exist or will the Financial Services Board have to intervene again, like the FSB had to do with the introduction of the Financial Advisory and Intermediary Services Act and Retail Distribution Review (RDR) as the instrument through which Treating Customers Fairly (TCF) is to be implemented?

**5. The importance for financial services providers to take note of, and learn from FAIS Ombud determinations to prevent the same mistakes**

During hundreds of training sessions attended by thousands of advisors since 2004, financial advisors and intermediaries have all agreed, without exception, that it takes hundreds of clients and hundreds of transactions over many years to establish a profitable and sustainable business, but it takes just one client complaint to ruin all that effort. This seems extremely unfair, but this is the reality of doing business as a financial advisor in an onerous regulatory environment. Advisors would therefore do well to seriously consider the *advice risk* they attract to their business.

One way to pay attention to *advice risk* is to learn from FAIS Ombud determinations. It is far cheaper to learn from the FAIS Ombud and to adjust one's processes and documentation accordingly than to be the subject of scrutiny by the Ombud's Office and the subject of public humiliation as a result of a determination. Sadly, it appears that many, if not most, providers only really learn from their own mistakes, not from the mistakes of others. In most cases these providers who learn from their own mistakes end up losing their reputation and eventually are charged with financial penalties that they can ill afford. In some cases they even face bankruptcy because of the reputational damage and onerous financial penalties due to the fact that, in many cases, their professional indemnity cover does not pay out.

Prevention is better than cure. Without exception, financial advisors who have been exposed publicly through FAIS Ombud determinations have acknowledged that, knowing what they know after the determination, they would have paid more attention to the requirements contained in the Act. In most cases they could have prevented the complaint if they merely learnt from previous determinations and adjusted their processes and record-keeping accordingly. In view of these acknowledgements by providers who had to pay the price for acts on non-compliance, I sincerely hope that this paper would highlight the importance of preventing client complaints as opposed to having to respond to a section 27(4) enquiry by the FAIS Ombud after a client complaint.

<sup>47</sup> <http://www.brainyquote.com/quotes/quotes/w/warrenbuff173493.html>

<sup>48</sup> See Traditional risk profiling flawed article by Gerard Ball, financial planner and founder of Investorrisk, <http://www.financialobserver.com.au/articles/traditional-risk-profiling-flawed>

**6. The key sections in the FAIS General Code of Conduct and the most common omissions or acts by financial services providers (advisors) that the Ombud of Financial Services Providers (FAIS Ombud) refer to in their determinations, which constitute non-compliance with the provisions of the Financial Advisory and Intermediary Services Act and its subordinate measures**

In an attempt to identify the essential (“Pareto” 80/20) components of risk profiling of clients, it is deemed necessary to identify those key sections in the Code of Conduct that advisors consistently fail to comply with. This is to ensure that I do not miss anything in my evaluation of those vital components pertaining to suitability and the components with regards to risk profiling in particular. This was done as a precautionary measure.

**6.1 Suitability of advice**

As already stated, statistics in South Africa and Canada confirm that the most frequent matters of complaints and prosecution relate to *suitability*.<sup>49</sup> Financial services providers must realise that it is easier for the FAIS Ombud to determine that an investment was appropriate or inappropriate, because they have the benefit of perfect hindsight. In most cases complainants have already suffered capital losses due to failed products or volatile investment markets and the FAIS Ombud then has to work back from that point towards the time when the transaction was concluded. Providers on the other hand do the transaction in the hope that the product will deliver what the product supplier promised it would. In many of the FAIS Ombud determinations the Ombud finds that the advice was not appropriate in accordance with the client’s *risk profile and needs*. Very often, the decision is based on the fact that, according to the Ombud, the investment was not appropriate because it was inconsistent with the client’s *risk tolerance*.<sup>50</sup> In other cases the FAIS Ombud found that the advisor did not consider the client’s *risk capacity*.<sup>51</sup>

Interestingly, there are no reported cases where the Ombud referred to the fact that the required risk was not assessed. When determinations go against advisors it has always been about risk tolerance and/or risk capacity, which implies that the latter two risks are deemed more important by the FAIS Ombud. If this is the case, it could have far-reaching implications for advisors and their clients. It should be interesting to note that according to the Financial Ombudsman Service in Australia, financial services providers that provide personal financial advice to retail clients are obliged to ensure the financial products they recommend are suitable having regard to each client’s objectives, financial situation and needs.<sup>52</sup> However, an important part of an FSP’s assessment of a client’s objectives, financial situation and needs is the knowledge of the client’s tolerance to risk.<sup>53</sup>

<sup>49</sup> See Investment Industry Regulatory Organization of Canada (IIROC) statistics (2014), page 22 and the results of my study pertaining to FAIS Ombud determinations

<sup>50</sup> See Ethel Ellouise Blessie (and others) v Shevgem Investments CC t/a Randsure Brokers (and other) 02202/09-10/KZN/1 (page 13 par 45 and par 47); Elise Barnes v D Risk Insurance Consultants CC (and another) 6793/10-11/GP 1 (page 32 par 41); Elizabeth Maria Catharina Van Schalkwyk v Investiplan (PTY) Ltd (and another) FAIS 04143/12-13/GP 1 (page 3 par 9); Aletta Roos v Johan Dudolph Kunneke t/a Johan Kunneke Brokers FAIS 05015/12-13/MP1 (page 11 par 31);

<sup>51</sup> See Aletta Roos v Johan Dudolph Kunneke t/a Johan Kunneke Brokers FAIS 05015/12-13/MP1 (page 10 par 28)

<sup>52</sup> Subsection 945A(1) of the Corporations Act as reported in the FOS guidelines (<https://www.fosorg.au/the-circular-6-home/risk-profiling-in-financial-advice-disputes/>)

<sup>53</sup> Australian Securities and Investments Commission (ASIC) Regulatory Guide 175 (issued May 2009) at RG175.118 as reported in the FOS guidelines (<https://www.fosorg.au/the-circular-6-home/risk-profiling-in-financial-advice-disputes/>)

As already stated, when it comes to investments, non-compliance with the suitability requirements contained in the General Code of Conduct are most frequently referred to in determinations that go against advisors. If this perception that risk tolerance and risk capacity are the most important risks to consider as part of an investor's risk profile is not addressed it could, and probably would, lead to advisors defaulting to conservative investments, which would mean that many investors will not achieve their objectives over the long term.

## 6.2 Ethics and professionalism

Section 2 of the Code of Conduct states that providers must render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and enhancing the integrity of the financial services industry. When the FAIS Ombud rule against financial services providers, failure to comply with these provisions are frequently referred to in their determinations. A study of these Ombud determinations show that, whilst the provisions contained in section 2 of the Code of Conduct as highlighted above are extremely broad, the FAIS Ombud applies a very strict interpretation to these provisions. These provisions are consistent with statutory provisions pertaining to the fiduciary duties for financial advisors in other countries.<sup>54</sup>

## 6.3 Due diligence on financial products

The failure of investment schemes such as Leaderguard and an unprecedented number of unlisted property syndications since 2009 have left tens of thousands of investors destitute, which has led to thousands of investor complaints being lodged with the FAIS Ombud's Office. If there is one thing that financial services providers have learnt through these terrible events, it is the importance of doing a proper due diligence on any financial product. The Ombud has made it very clear in these determinations that if providers do not provide evidence that they have done a proper due diligence on investment products, they will not be able to prove that they have performed a proper risk assessment of the relevant product. This would lead to limited risk disclosures, which would ultimately lead to clients not being put in a position to make informed investment decisions. A proper due diligence would put an advisor in a position to disclose and explain the potential risks (downside) to the investments concerned, which will assist the client in determining his / her risk tolerance in respect of the applicable investment.

Again the provisions of section 2 of the Code of Conduct, the failure to render financial services honestly, fairly, with due *skill, care and diligence*, and in the interests of clients and the integrity of the financial services industry form the basis of most of the Ombud's determinations against providers.

## 6.4 Full and frank disclosures of benefits, terms, conditions, exclusions, risks and fees

Non-compliance with the provisions of section 7 of the Code of Conduct is a regular feature in FAIS Ombud determinations. A provider must-

- (a) *provide a reasonable and appropriate general explanation of the nature and material terms of the relevant contract or transaction to a client, and generally make full and frank disclosure of any information that would reasonably be expected to enable the client to make an informed decision.*

The non-disclosure of investment risks in plain and simple language in particular received a lot of attention in cases where determinations are made against providers.

### 6.5 Putting clients in a position to make informed decisions

Failure to comply with sections 3(1)(a)(ii), (iii) and 8(2) of the Code of Conduct are also frequent features in FAIS Ombud determinations. When a provider renders a financial service-

- (a) representations made and information provided to a client by the provider-
  - (ii) must be provided in plain language, avoid uncertainty or confusion and not be misleading; and
  - (iii) must be adequate and appropriate in the circumstances of the particular financial service, taking into account the factually established or reasonably assumed level of knowledge of the client.

In terms of section 8(2) of the Code of Conduct *a provider must take reasonable steps to ensure that the client understands the advice and that the client is in a position to make an informed decision.* Using plain language pertaining to complex issues such as required risk, risk capacity and risk tolerance to avoid uncertainty and confusion is not as simple as it seems.

I would argue that compliance with the fiduciary duties in terms of section 2 of the Code of Conduct, the suitability requirements contained in section 8(1)(a), (b) and (c), the due diligence requirements and the disclosure requirements as prescribed in section 7 of the Code of Conduct will go a long way to put an investor in a position to make an informed decision. However, in its simplest form, if an investor is not informed that his/her investment is subject to up and down movements in the market and by how much his/her investment value may decline over a given period, such as 12 months given poor market conditions, he/she will not be in a position to make an informed investment decision.

### 6.6 Recording of advice and maintaining appropriate records

According to section 3(2) of the General Code of Conduct:

- (a) *A provider must have appropriate procedures and systems in place to-*
  - (i) *record such verbal and written communications relating to a financial service rendered to a client as are contemplated in the Act, this Code or any other Code drafted in terms of section 15 of the Act;*

Failure to maintain proper records lead to providers' inability to provide the evidence required by the Ombud to establish the facts.

### 6.7 Record of advice

From the FAIS Ombud's determinations it is clear that the record of advice is arguably the least understood document by financial services providers, which at the same time has had a profound impact in almost every outcome.

Section 9 (1) states that a provider must, ..., maintain a record of the advice furnished to a client as contemplated in section 8, which record must reflect the basis on which the advice was given, and in particular-

- (a) *a brief summary of the information and material on which the advice was based;*

- (b) *the financial product which were considered;*
- (c) *the financial product or products recommended with an explanation of why the product or products selected, is or are likely to satisfy the client's identified needs and objectives; and*

*Provided that such record of advice is only required to be maintained where, to the knowledge of the provider, a transaction or contract in respect of a financial product is concluded by or on behalf of the client as a result of the advice furnished to the client in accordance with section 8.*

- (2) *A provider, other than a direct marketer, must provide a client with a copy of the record contemplated in 9(1) in writing.*

**Explanation:**

An in-depth analysis of this section will show that, although this is an important document, the intention of the regulator was not for the record of advice to be the beginning and the end of all records to be maintained under FAIS. However, for purposes of this paper, the record of advice will not be commented on. Suffice to say that the non-compliance with section 9 of the Code of Conduct was the reason for the down-fall of many providers.<sup>55</sup> In the words of the FAIS Ombud:

*After taking reasonable steps to seek from the client appropriate and available information, there is a duty on Respondent to identify the financial product that will be appropriate to the client's risk profile and financial needs. That these requirements as encapsulated in Section 8 (1) of the Code were indeed met must be evidenced by the record of advice, which is required to be maintained in terms of Section 9 (1) of the code.<sup>56</sup>*

<sup>55</sup> Elizabeth Maria Catharina Van Schalkwyk v Investiplan (PTY) Ltd (and another) FAIS 04143/12-13/GP 1 (page 10 par 33.6); Gert Corneulis Johannes Van Vuuren (and another) v Kampstone Financial Services CC FAIS 02156-09/10 GP(1) (page 9 par 11); Ethel Ellouise Blessie (and others) v Shevgem Investments CC t/a Randsure Brokers (and other) 02202/09-10/KZN/1 (page 11 par 40)

<sup>56</sup> Vinolia Ntombekaya Bam-Mgugunyeka v U C Private Wealth t/a Liberty Moon Investments (and others) FAIS 03045/09-10/WC/(1) (page 13 par 42)

**7. Explaining why the Ombud's office frequently encounters a disconnect between a complainant's risk tolerance, as calculated according to questions laid out in a risk profile document and the complainant's actual circumstances**

**7.1 Poor questions, inappropriate weightings**

In accordance with the UK and Canada reports, top financial planners and commentators in South Africa have expressed concern that questionnaires use poor questions and answer options and have over-sensitive scoring or attribute inappropriate weighting to answers.<sup>57</sup>

**7.2 Flawed questionnaires**

Also in accordance with the UK and Canada reports, top financial planners and commentators in South Africa have argued that flaws in questionnaires can lead to inappropriate conflation or interpretation of customer responses<sup>58</sup>

**7.3 Vague descriptions**

Top financial planners in South Africa have found that many examples of descriptions have been found to be vague and do not effectively explain or differentiate levels of risk, which is consistent with the findings in the UK and Canada.<sup>59</sup>

**7.4 Inappropriate products**

Even where the risk profile has been correctly assessed, the product or portfolio does not always match this profile.<sup>60</sup>

In many of the reported determinations providers failed as a result of no or poor product due diligence.<sup>61</sup>

**7.5 Customer risk category descriptions are unclear or misleading.<sup>62</sup>**

Risk category descriptions are unclear simply because they are not properly defined and quantified. Most of the risk categories such as Conservative, Moderate and Aggressive have some general, subjective description which nobody can quantify and the moment a risk category cannot be quantified, it leads to subjective interpretation. Then again, some questionnaires focus entirely on risk tolerance.<sup>63</sup> This implies that a client's risk tolerance is equivalent to his or her risk profile, which is misleading.

**7.6 Descriptions or illustrations do not clearly quantify the level of risk.<sup>64</sup>**

This is arguably one of the biggest contributors to the suitability problem that currently exists globally. If risk can be properly defined from an investor's perspective and properly quantified, it would solve many problems with regards to risk profiling and suitability.

<sup>57</sup> FSA Report March 2011, page 3; Swanepoel, Risk profile questionnaires: Inappropriate questions lead to inappropriate advice, FSB Bulletin, First quarter 2007, p 12-15

<sup>58</sup> FSA Report March 2011, page 3; Swanepoel, Risk profile questionnaires: Inappropriate questions lead to inappropriate advice, FSB Bulletin, First quarter 2007, p 12-15

<sup>59</sup> FSA Report March 2011, page 4

<sup>60</sup> FSA Report March 2011, page 4

<sup>61</sup> Ethel Ellouise Blessie (and others) v Shevgem Investments CC t/a Randsure Brokers (and other) 2202/09-10/KZN/1 (page 12 par 42); Vinolia Ntombekaya Bam-Mgugunyeka v U C Private Wealth t/a Liberty Moon Investments (and others) FAIS 03045/09-10/WC/(1) (page 6 par 18) and (page 10/11 par 35)

<sup>62</sup> FSA Report March 2011, page 16

<sup>63</sup> See Profile's Unit Trusts & Collective Investments (September 2013), p 83

<sup>64</sup> FSA Report March 2011, page 16

### 7.7 Description of the investment strategy is inconsistent with most customers' understanding of the risk posed by the category description, i.e. cautious.<sup>65</sup>

One of the reasons that the description of the investment strategy is inconsistent with most customers' understanding of the risk posed by the category description, i.e. cautious is the fact that the term cautious is left wide open for interpretation. In the Oxford Dictionary it is defined as follows:

*A cautious person is nervous that something may be dangerous or unwise, so they only do it very slowly after a lot of thought.*<sup>66</sup>

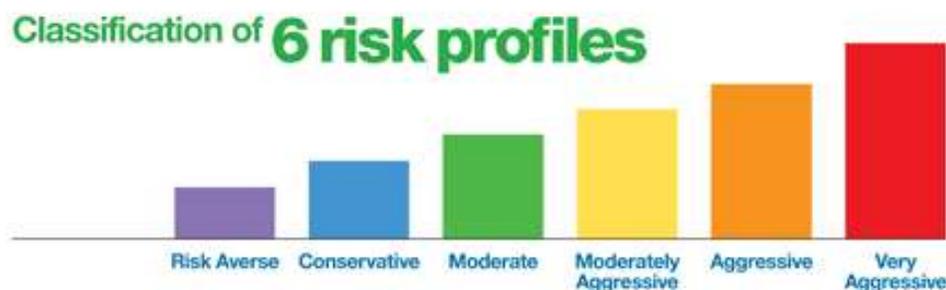
Some people are more cautious than others and as a result this description is entirely in the eye of the beholder. If the category description is not quantified, there will always be room for subjective interpretation.

Other examples: A random google search on risk profile provide the following information:

#### Understand Your Investment Profile<sup>67</sup>

*Your investment objective, experience, financial situation and attitude towards investment risk are important factors that affect any investment decision you may make. Therefore, understanding your investment profile is an important step in making a wise investment decision. We have devised a "Customer Investment Profile" questionnaire. The results will be available as you submit the completed questionnaire. You will get the results on your general attitude towards investment risks by reference to a classification of six Risk Profiles – namely 1-Risk Averse, 2-Conservative, 3-Moderate, 4-Moderately Aggressive, 5-Aggressive and 6-Very Aggressive. Taking into account your Risk Profile and your personal circumstances, you could consider a range of investment products that fit your own classification.*

#### Illustration:



#### Definitions

In the absence of a quantifiable definition of the each of the aforementioned categories, the drafters of these risk profiling questionnaires have two options, namely draft their own definition or use the normal meaning of the words as defined in the dictionary.

*For example:*

<sup>65</sup> FSA Report March 2011, page 16

<sup>66</sup> The Oxford Advanced Learner's Dictionary, Oxford University Press 2005, p 224

<sup>67</sup> <https://www.sc.com/hk/personal-banking/investments/customer-investment-profile/en/>

**Risk averse**

Risk averse means “expose to chance of loss opposed/disinclined”<sup>68</sup> or simply *opposed to chance of loss*.

**Conservative**

Conservative means “tending to conserve/averse to rapid changes/seeking to preserve parts as far as possible/moderate/cautious/avoiding extremes”<sup>69</sup> or simply *cautious and seeking to preserve*. The Oxford Business English Dictionary defines conservative as *not taking or involving unnecessary risk*.<sup>70</sup> I respectfully submit that all these concepts by definition are abstract, vague and entirely open for interpretation and it will always be the case, unless some objective, measurable benchmark is added.

**Moderately conservative**

Moderately means “avoiding extremes/low/temperate in conduct or expression”<sup>71</sup> moderate/cautious/avoiding extremes”<sup>72</sup> or simply *cautious and seeking to preserve*. The Oxford Business English Dictionary defines moderate as *neither very good / large etc. nor very bad / small, i.e. reasonable*.<sup>73</sup> Moderately means *to an average extent, within reasonable limits*.<sup>74</sup> As highlighted above, The Oxford Business English Dictionary defines conservative as *not taking or involving unnecessary risk*.<sup>75</sup> This begs the question: How does one use these definitions without leaving it open for interpretation? Surely it must be quantified.

**Moderate**

Again, moderate means “avoiding extremes/low temperate in conduct or expression”<sup>76</sup> or simply *cautious and seeking to preserve*. The Oxford Business English Dictionary defines moderate as *neither very good / large etc. nor very bad / small, i.e. reasonable*.<sup>77</sup> Moderately means *to an average extent, within reasonable limits*.<sup>78</sup> Again, what is reasonable for one person may be totally unreasonable for another. There is no objective benchmark.

**Moderately aggressive**

Moderately aggressive means avoiding extremes/low “offensive/disposed to attack/forceful/self-assertive”<sup>79</sup> or simply *cautious and seeking to preserve*.<sup>80</sup> Moderately means *to an average extent, within reasonable limits*.<sup>81</sup> According to the Oxford Advanced Learner’s Dictionary aggressive means angry and behaving in a threatening way.<sup>82</sup> So how does one measure *being angry and behaving in a threatening way within reasonable limits*?

<sup>68</sup> Sykes 1983:60

<sup>69</sup> Sykes 1983: 200

<sup>70</sup> The Oxford Business English Dictionary, Oxford University Press 2005, p 111

<sup>71</sup> Sykes 1983: 650

<sup>72</sup> Refer to conservative above

<sup>73</sup> The Oxford Business English Dictionary, Oxford University Press 2005, p 353

<sup>74</sup> See The Advanced Learner’s Dictionary, Oxford University Press 2005, p 946

<sup>75</sup> The Oxford Business English Dictionary, Oxford University Press 2005, p 111

<sup>76</sup> Sykes 1983: 650

<sup>77</sup> The Oxford Business English Dictionary, Oxford University Press 2005, p 353

<sup>78</sup> The Oxford Advanced Learner’s Dictionary, Oxford University Press 2005, p 946

<sup>79</sup> Sykes 1983:18

<sup>80</sup> My wording

<sup>81</sup> The Advanced Learner’s Dictionary, Oxford University Press 2005, p 946

<sup>82</sup> The Oxford Advanced Learner’s Dictionary, Oxford University Press, p 29

### *Aggressive*

Aggressive means “offensive/disposed to attack/forceful/self-assertive”<sup>83</sup> Again, according to the Oxford Advanced Learner’s Dictionary aggressive means *angry and behaving in a threatening way*.<sup>84</sup> If this is the way an aggressive investor is defined, providers seem to agree that *there is only one kind of aggressive investor and that is one that has just lost money*. Unfortunately then his aggression, anger and threatening behaviour is aimed at the adviser.

During the FIA roadshows and the FPI Refresher sessions in 2015 these so-called risk profiles were put to the test. Five hundred and fifty four (554) financial advisors who are licensed to provide investment advice participated in the survey. The first question participants were requested to answer was how they would classify themselves in the categories from conservative to aggressive. The second question was, given their own classification, what is their expected rate of return p.a. over a five year period in the current environment (SA had close to a 6% inflation rate at the time). The third question was, given their risk category and their expected return, what “loss” in the value of their investment they would be willing to accept over any 12 month rolling period over the investment term. The results from this survey explain some of the problems that exist with regard to risk profiling. It also confirms why the FAIS Ombud found that there is a “disconnect” between risk categories, expected returns and their risk tolerance. The table below is an abbreviated summary of the results.

Description	Conservative	Moderate	Aggressive
Lowest expected return	6% p.a.	6% p.a.	12% p.a.
Highest expected return	16% p.a.	25% p.a.	21% p.a.
Lowest “loss” tolerance	0%	-3%	-8%
Highest “loss” tolerance	-12%	-10%	-40%
Lowest combination	6% / -2%	6% / -3%	12 / -10%
Highest combination	16% / -1%	25% / - 10%	21% / -25%

### **Explanation and analysis**

The purpose of the exercise was to establish whether people interpret the various risk categories, which are so frequently used and accepted by the financial services industry, differently. Suspicions were confirmed by these surveys, but to the extent that the results raise serious concerns about the education levels of some of the advisor participants. In an inflation environment of 6% one “conservative” advisor expects 6% p.a. whereas another in the same category expects a return of 16% p.a. Two advisors, both of which described themselves as conservative are worlds apart (10% p.a.) when their expected returns are quantified.

The lowest expected returns for the *conservative* category and the *moderate* category were exactly the same at 6% p.a., which matched the inflation rate at the time. The first conclusion that should be drawn from this is that these terms are extremely subjective and without an objective benchmark, there will always be a high probability of a disconnect between advisors and their clients. The fact that the highest expected return of 25% p.a. (19% p.a. in real terms) for a *moderate* investor was higher than the highest expected return for an *aggressive* investor at 21% p.a. (15% p.a. in real terms) show that these categories are *meaningless* without an objective and realistic benchmark.

These results indicate that many participants have unrealistic return expectations, especially in view of the fact that the asset class with the highest average historical return in SA over the long term, namely equities, have not performed higher than 8% p.a. in real terms. If some advisors have unrealistic return expectations themselves, one has to ask the question: How will they be able to provide sound and suitable advice to their clients?

In one instance, the same advisor that expects a return of 16% p.a. over a 5 year term, is not willing to accept more than a -1% “loss” in value of his investments over any 12 month rolling period, which is unrealistic to say the least. It is a universally accepted principle of investment that risk rises with the potential for higher returns.<sup>85</sup>

According to these results, the highest expected return from a conservative investor is higher than the lowest expected returns from an aggressive investor, which proves that this type of risk profiling is flawed and will continue to cause confusion and be instrumental to inappropriate advice if not abolished.

## 8. Reasons why risk profile questionnaires can be interpreted in several ways and are not always specific or relevant to the investment at hand

There are a number of reasons why risk profile questionnaires can be interpreted differently and not always specific or relevant to the investment at hand.

### 8.1 The different categories of investors are defined differently by the various industry stakeholders, which leaves a lot of room for different interpretations. For example:

- 8.1.1 The *conservative investor* is looking for long-term capital preservation, insulated from extreme volatility. They are heavily invested in bonds and cash. The capital base of the investment is maintained with little potential for growth in value.<sup>86</sup>

There are various terms in this definition that could each be interpreted differently, such as capital preservation, extreme volatility and little potential for growth. Capital preservation could mean preserving capital in real terms, which can mean anything from inflation plus 0% p.a. to inflation plus 5% p.a. in the South African context. What may be extreme volatility for one person may not be that extreme for another. Little potential is in the eye of the beholder.

- 8.1.2 A *defensive* portfolio is suitable for investors seeking a relatively low-risk investment.<sup>87</sup> What may be relatively low risk for one person, may be totally unacceptable for another.

- 8.1.3 A *conservative investor* seeks to protect capital and is somewhat concerned when this does not occur.<sup>88</sup> Again, the term “somewhat” means different things to different people.

- 8.1.4 The *moderate investor* is looking for both income and growth. The equity content dominates the bonds and cash content. The portfolio, however, would tend to be less volatile than the market as a whole.<sup>89</sup>

<sup>85</sup> Profile’s Unit Trusts & Collective Investments, September 2013, p 85

<sup>86</sup> See the Financial Planning Handbook

<sup>87</sup> See Your investment Risk Profile by Lowe Lippman Financial Services

<sup>88</sup> See Investment risk profiles by Apt. Wealth Planners

<sup>89</sup> See the Financial Planning Handbook by Botha, Rossini, Geach, Goodall, Du Preez and Rabenowitz 2014, page 363

Income and growth are open for interpretation and less volatile than the market does not in any way give an indication of how much income or growth, which again leave a lot of room for interpretation.

- 8.1.5 The *moderate* portfolio is suitable for investors seeking and investment which balances risk and return.<sup>90</sup>

Like all the other descriptions, this definition is wide open for interpretation by the reader.

- 8.1.6 The *moderate or balanced* investor is more focussed on the possible gains, but also keeps in mind the possible losses.<sup>91</sup>

This is a very general statement which is not quantified and therefore relative to other people.

- 8.1.7 The *aggressive investor* is looking for a high level of aggressive growth. They would invest a portion of funds available in the shares of companies showing a high growth potential. This portfolio can be highly volatile resulting in the investor requiring a long-term approach to the investment.<sup>92</sup>

Question: *How* high should this level of growth be and *how* volatile will the investment be?

- 8.1.8 The *growth* portfolio is suitable for investors seeking a higher return investment.<sup>93</sup>

Question: Seeking a higher return compared to whom?

- 8.1.9 The *growth* investor is interested in capital and accumulating wealth more quickly relative to your investment timeframe. The investment time horizon is for the long term, 7 years or more.<sup>94</sup>

Question: “More quickly” compared to whom?

- 8.2 Again, the fact that downside risk is not adequately quantified in simple and understandable terms, is arguably one of the greatest contributors of confusion and the “disconnect” that exist between the risk tolerance of investors and the outcomes of risk profiling questionnaires as reported by the FAIS Ombud.

- 8.3 There is no industry standard with a common fundamental framework that all providers have bought into as the basis for risk profiling, which means that there are many different variations of risk profiling questionnaires, each with its own questions and weightings.

- 8.4 Every provider (firm) or advisor (representative) decide which risk profile questionnaire would work for them, regardless of their knowledge level or experience, which leads to sub-standard questionnaires causing confusion in the industry.

- 8.5 There are fundamental flaws and/or differences in some of the questionnaires, such as:

- 8.5.1 The required return is not quantified, and as a result the required risk cannot be determined and therefore it would be impossible to find an appropriate solution as everyone will have his or her own opinion and the investment cannot be managed properly

<sup>90</sup> See Your investment Risk Profile by Lowe Lippman Financial Services

<sup>91</sup> See Investment risk profiles by Apt. Wealth Planners

<sup>92</sup> See the Financial Planning Handbook 2014, page 363

<sup>93</sup> See Your investment Risk Profile by Lowe Lippman Financial Services

<sup>94</sup> See Investment risk profiles by Apt. Wealth Planners

- 8.5.2 Risk capacity is not quantified, and as a result every person will have their own opinion of whether the amount is appropriate or not
- 8.5.3 Risk is not defined and not quantified, which means that it is a moving goalpost depending who is looking at it
- 8.5.4 Risk tolerance is not properly quantified, which leads to subjective interpretation
- 8.5.5 Few questions actually present respondents with a clear risk-return trade-off and those questions which do involve a trade-off present a vague one.<sup>95</sup>
- 8.5.6 The age and investment term debate continues  
Some providers deem an investor's age more important than the term of investment.<sup>96</sup> At age 60+ the Ombud's Office describes an investor as elderly and their determinations imply that investors in this age group and older are, or should be conservative.<sup>97</sup> However, advisors are challenged with an average life expectancy and investment term that applies to that same investor of more or less twenty years. If the questionnaire only includes the age of the investor (60 in this case) and allocates a significant weighting to the outcome, the questionnaire will more than likely support a "conservative outcome", which will lead to a "conservative" portfolio. However, over 20 years a conservative portfolio may not outperform inflation over the long term. Therefore, I respectfully submit that any risk profile questionnaire that does not include investment term and required return over that investment period will be insufficient to provide suitable advice.
- 8.5.7 Some providers include questions that are unrelated to the investment at hand. For example:
- 8.5.7.1 A young company offers a market-related salary plus one of several bonus options. Which would you choose?<sup>98</sup>
- Question: How does this question relate to the investment objective, risk required, risk tolerance and risk capacity that applies to this particular investment?
- 8.5.7.2 When I buy car insurance I...<sup>99</sup>
- Question: How does this question assist in measuring the investor's investment objective, risk required, risk tolerance and risk capacity that applies to this particular investment?
- 8.5.7.3 At a fun day at the track you are given R500 by the party host. Would you rather...<sup>100</sup>

<sup>95</sup> See The Treatment of Risk in Financial Planning by Tom Valentine published in the Journal of Law and Financial Management (2003)

<sup>96</sup> Profile's Unit Trust & Collective Investments Handbook 2016, p 114

<sup>97</sup> Black v John Alexander Moore and Johnsure Investments CC

<sup>98</sup> Profile's Unit Trust & Collective Investments Handbook 2016, p 116

<sup>99</sup> Profile's Unit Trust & Collective Investments Handbook 2016, p 116

<sup>100</sup> Profile's Unit Trust & Collective Investments Handbook 2016, p 114

Question: How does this question relate to an R 1 000 000 investment and how can a gamble with a gift of R 500.00 be compared with R 1 000 000 hard earned retirement money that must sustain one for a lifetime?

## 9. How to disclose risk in clear unambiguous language

From a financial planning point of view the client should be at the center of every disclosure. As a result, when it comes to suitability, risk and risk profiling, I propose that risk should be explained and disclosed from a client perspective. Firstly, investors understand gains (returns) and losses. As a result I believe that all the stakeholders should appreciate the fact that investors see risk in the following ways:

### 9.1 *Chance of loss of capital*

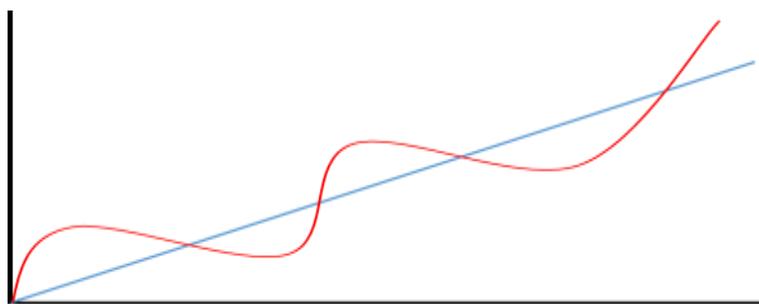
Financial planning professionals know that past performance of any investment is not necessarily a guide to future returns and it has to be disclosed to clients that, in view of economic, political and market factors, investment performance cannot be guaranteed. It must be disclosed and explained that there are certain risks associated with investing in financial products. Risk refers to the inherent *risk of capital loss* or fluctuation in portfolio valuations over time. If a client invested in South Africa towards the end of 2008 he/she could have experienced a capital loss of 20% or more in the value of his investment over the short term at some point in 2009. We could argue that it is not a loss, because the investment term may have been 10 years and technically we would be right. We could argue that it is a “paper loss”, and technically we would be correct, but from the client’s perspective he/she suffered a capital loss at that point and as a profession I propose that we should recognise it.

### 9.2 *Chance of a reduction in the value of an investment portfolio as a result of market fluctuation*

Financial planning professionals know that the value of the investments and income may rise as well as fall over the investment term as market conditions change. As a result, there is the risk that the client may experience a decline in the market value of his/her investment from time to time. It therefore must be disclosed to investors that there are various risks involved in investing in local and international financial markets due to fluctuations in market conditions. With international investments there is an additional risk arising from fluctuations in international currency exchange rates. Investors must be informed that it is possible that emerging markets may be more volatile than developed markets. Foreign investment may differ from its South African counterpart and it may, for example, not be possible to liquidate certain foreign investments at short notice as such instruments has higher liquidity risk. There are also various risks involved in the use of futures, and/or other derivative instruments. Further, offshore investments in currencies other than the base currency of the Investor’s portfolio will expose the investor to the possible currency risk of the offshore investment and the movement of exchange rates may affect, unfavourably as well as favourably, any gain or loss on the investment or the market value of the investment itself.

It may be helpful to illustrate the difference between an inflation plus 2% p.a. portfolio and an inflation plus 5% p.a. If achieving an investment return that outperforms inflation by say 2% p.a. is the investor’s primary objective, it must be explained to, and ultimately accepted by, the investor that this objective cannot be achieved without accepting some risk (chance of a reduction in the investment value of the portfolio from time to time) and volatility (up and down movements) in the investor’s portfolio?

*Illustration of an inflation plus 2% target return portfolio over a minimum term of 3 years*



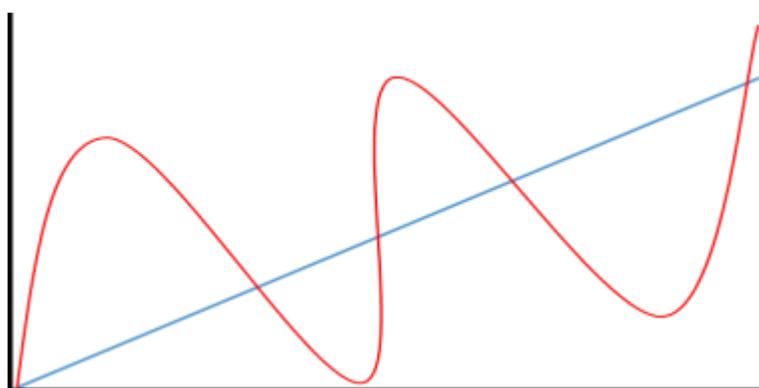
\* The blue line represents the target return

This illustration also highlights the importance of investment term and not to liquidate the portfolio simply as a result of market movements as it would then result in a real capital loss.

In the event that an investor seeks a higher return than inflation plus 2% p.a. it must be disclosed and explained that the investor will have to invest in a portfolio with a higher risk profile and that the risks inherent in investments with a higher risk profile are greater than the risks in investments with a lower risk profile, such as the inflation plus 2% p.a. portfolio. It should be disclosed, explained and ultimately agreed to that such higher risk investments may be subject to sudden and sometimes substantial fluctuations in value.

If an inflation plus 5% p.a. is the investor's primary objective, it must be disclosed, discussed and ultimately accepted by the investor that the objective cannot be achieved without accepting a higher level of risk (chance of a reduction in the investment value from time to time) and increased volatility (up and down movements) over the short- to medium term (1-3 years) in order to achieve the investor's objective over the long term (5 years and longer).

*Illustration of an inflation plus 5% target return portfolio over a minimum term of 5 years*



\* The blue line represents the target return

Again, this illustration also highlights the importance of investment term and not to liquidate the portfolio simply as a result of market movements as it would then result in a real capital loss.

I would be the first to acknowledge that these disclosures of risk are extremely basic and this explanation will never be a contender for the Nobel-prize in economics, but that is exactly the point – to disclose the basic elements of risk in clear and simple language so that everyone from the layman to the astute investor can understand it.

### 9.3 *The risk of the portfolio not keeping pace with inflation or outperforming inflation by a big enough margin to sustain the investor's standard of living over the long term*

This disclosure could be illustrated through a simple cash flow projection by using a projected return equal to a cash return, which in South Africa has been close to the inflation rate (before tax). In most cases the projection will show that the investor cannot afford to invest his/her capital in a portfolio that simply matches a cash return or inflation over the long term. If one takes a retirement plan for example, I would argue that, without a cash flow analysis that illustrates to an investor what return is required to sustain the investor's lifestyle or when his/her money will potentially run out, no investor would be in a position to make an informed investment decision.

### 9.4 *The risk of not achieving the investor's objectives*

As highlighted before, the suitability requirements in section 8(1)(a) states that:

A provider . . . must, prior to providing a client with advice- *take reasonable steps to seek from the client appropriate and available information regarding the client's financial situation, financial product experience and objectives to enable the provider to provide the client with appropriate advice;*

Professional financial planners know that client *objectives* have to be **SMART**. In the case of investors their objectives have to be:

#### Specific

I would argue that, a comprehensive cash flow analysis at retirement for example, which include specific income needs, ad hoc capital requirements, expected increases over the life-expectancy of the investor would illustrate what investment return would be required to sustain the investor's lifestyle or when his/her money will potentially run out. This is how objectives should be determined and not whether a risk profile questionnaire indicates that an investor is conservative or moderate. In this context and given the various definitions and interpretations associated with terminology such as *conservative*, *moderate* and *aggressive*, these risk categories are vague and confusing.

#### Measurable

Many, if not most, experienced financial planners will confirm that investments is all about managing expectations. This principle "*If you can't measure it, you can't manage it*" is particularly relevant to investment advice. Although this phrase belong to W. Edwards Deming, author of *The New Economics*, page 35, this is a maxim that ranks high on the list of quotations attributed to the late Peter Drucker, often referred to as the father of modern management.

If objectives are not quantified, the associated risks cannot be quantified. If objectives and risk are not quantified, I would argue that it is impossible for advisors to explain risk to investors and as a result, advisors will never be in a position to lead a client to make an informed decision and it will be impossible to manage clients' expectations. We therefore desperately need the concept of risk and the risk profile of a client to be

quantified, so that it can be objectively measured and better managed. Given the results of the FIA and FPI member survey results and the various outcomes of expected returns versus potential “losses”, again I would argue that risk categories such as conservative, moderate and aggressive are meaningless, because in their current form they cannot be measured, nor managed in accordance with investor’s expectations.

**Attainable**

Risk and return are inseparable, but the risk/return trade-off must be realistic and attainable. From the FIA and FPI member surveys that were conducted, it was clear that some risk/return expectations are totally unrealistic and unattainable. For example:

<b>Return/risk trade-off: Conservative</b>	<b>Moderate</b>	<b>Aggressive</b>
16% / -1%	25% / - 10%	21% / -25%

A conservative investor that expects a rate of return of 10% p.a. in real terms over a 5 year investment period clearly has an unrealistic expectation, but to only accept a “loss” of -1% over any 12 rolling period, given the expected return is even more unrealistic and totally unattainable. The same argument applies to the moderate and aggressive category as illustrated above. It is only when the investor’s objective is specific, measurable and attainable that an advisor can provide an indication of what the potential “loss” could be which an investor either has to accept, or default back to his/her risk tolerance threshold and accept investment returns that are less than the required return to maintain his/her standard of living. The risk/return trade-off is the ultimate decision an investor will have to make at the end.

A realistic, attainable risk/return trade-off starts with the required return needed to achieve the client’s objectives. A 16% p.a. (10% p.a. in real terms) expected investment return from a conservative investor guarantees two things – extreme disappointment from both investor and advisor and a potential FAIS Ombud complaint against the advisor at some point.

**Relevant**

An investor may have different investment objectives. A certain amount may be earmarked for a child’s education, an overseas vacation, retirement or an emergency fund for example. Every investment has a unique purpose and objective and as a result the required return, investment term and potential downside has to be relevant and applicable to each and every investment. Each investment objective is unique and the questions and assumptions made in obtaining information and providing advice have to be relevant and aimed at the specific investment.

**Time-bound**

The investment term is absolutely vital in determining the customer’s financial needs and it plays a key role in the evaluation of the customer’s risk profile as defined in this paper. Not one of the risk components can be properly quantified without taking the investment term into consideration. Despite the fact that The Advisor’s Risk Profiling Workgroup has agreed in 2014 that the investment term, not the customer’s age, should be the primary consideration in determining the customer’s needs and risk profile, many product suppliers and other market commentators persist in using the investor’s age as the leading question in these questionnaires.<sup>101</sup> Even the FAIS Ombud appears to use the age of complainants as the starting point, which I respectfully submit is incorrect from a financial planning point of view.

<sup>101</sup> Profile’s Unit Trust & Collective Investments Handbook 2016, p 114

On the 21<sup>st</sup> of April 2016 I consulted with a Certified Financial Planner® Practitioner who completed her employer's risk profiling questionnaire perfectly. The employer is one of the leading product suppliers in South Africa and as the FSP (Firm) they prescribe which forms must be completed. She ticked all the boxes and her client was categorized as an aggressive investor. Unfortunately for her, her employer's risk profiling questionnaire is flawed, because for one, the leading question in their questionnaire was the client's age, but nowhere in the questionnaire did it enquire about the investment term. If the questionnaire contained an enquiry pertaining to the investment term, the advisor would have been prevented to invest the client's money into an equity fund for a period of only six months. I suggested to the advisor to settle with the client, because the FAIS Ombud undoubtedly would have found in favor of the client. This is a classic case of a product supplier that drafted a traditional risk profiling questionnaire without paying due consideration to the fundamentals of risk profiling, leaving their representatives exposed to FAIS Ombud complaints. This is also a classic example of ticking all the compliance boxes, but the outcome did not serve the best interests of the client.

Industry stakeholders should take note that some of the international regulators are providing specific suitability guidelines to advisors, which specifically refers to investment term.<sup>102</sup> According to CFA Institute, a member or candidate should put the needs and circumstances of each client and the client's investment objective into a written policy statement and as part of its investor constraints must consider the time horizon of the investment.<sup>103</sup> Drafters of risk profiling questionnaires must give due consideration to the importance of the investment term as objective and time-horizon goes hand in hand. A 60-year old still has close to 20 years to sustain his/her lifestyle, which means that a professional advisor's plan can never start or finish with the investor's age. When doing a cash flow projection, the investment term is a vital component of the advisor's information when determining the client's needs, goals and objectives. It is of fundamental importance for both the advisor and client to understand for how long the client needs to invest in order to meet his/her goals.

#### 9.5 *The risk of having to adjust the investor's living standards*

The harsh reality is that, in South Africa, close to 97% of investors that receive financial advice ultimately have to choose between investing their money "conservatively" in the bank and having to adjust their living standards later or taking calculated risks to achieve higher returns, so that they may not have to adjust their living standards. This is a very real risk for most investors in South Africa. The risk of being dependent on others in later years may even result in investors taking on investment risks that they would not normally accept.

## 10. Common trends in the client interaction and advice process that eventually lead to client complaints, which could potentially lead to better pre-emptive measures by providers

From all the FAIS Ombud determinations that I studied and after all the individual consultations with financial advisors who have been taken to the FAIS Ombud, there is a common trend, which could be of assistance to financial advisors in particular. Investors are drawn to the prospect of higher than market related returns for a number of reasons. Greed, desperation and fear of being dependent on others are the most common and these factors create a market for advisors to seek alternative investment products that can meet their desire of receiving higher returns. In some cases before the FAIS Ombud there is evidence of advisors who presented traditional investment products to clients in order to provide different options and the clients selected the product which offered the highest return.<sup>104</sup>

Product suppliers in South Africa are extremely innovative and some of them design truly world-class investment products. However, some product suppliers know that many advisors are also drawn to higher financial incentives and if they want to sell many of their products, they will have to offer above market related incentive structures or commissions payable to those advisors who sell their products. The common denominators of all the failed investment schemes in South Africa are investment products that offered higher than market related returns and it paid higher than market related commissions.<sup>105</sup>

One of the trends that is evident from all the cases that served before the FAIS Ombud is that clients tend to focus on investment returns which are normally in bold font and in colour when they make their investment decisions, but when things go wrong, all of them focus on the fine-print, which is in small font. It is important for all the stakeholders in the financial services industry to note that, when investors want to invest money, they tend to focus on returns, but when they lose money, they tend to focus on the advisor who put their money into the investment. When investors do start to focus on the advisor, they have the professional assistance of the Office of the FAIS Ombud, who investigates every case with a magnifying glass and leaves no stone unturned to ensure that the FSP (Firm) and representative (advisor) complied with the FAIS Act and the General Code of Conduct in particular.

From my analysis of more than thirty FAIS Ombud determinations pertaining to investments it is very clear that, given their statutory mandate, the Ombud's Office leaves no stone unturned to gather all the facts, but when there is no evidence to support the financial service provider's compliance with the provisions of the Act and/or Code of Conduct, the FAIS Ombud applies a very strict interpretation of the Act and will rule in favour of the client every single time. It is therefore imperative that financial advisors have all the evidence as required in terms of the Act to verify their version of the facts.<sup>106</sup>

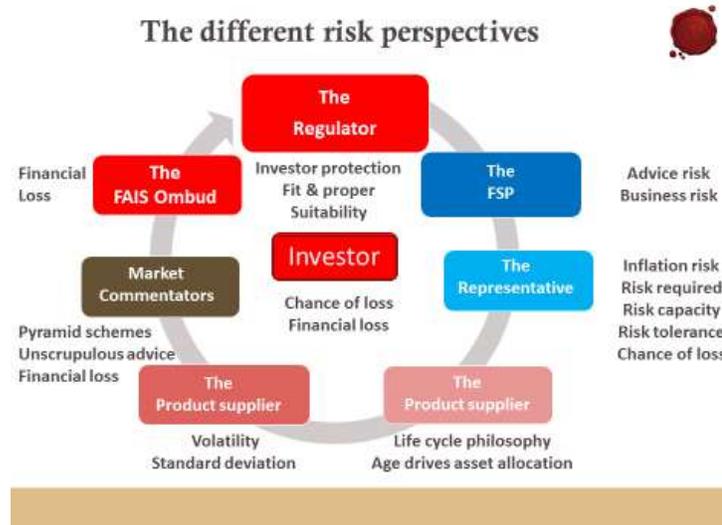
<sup>104</sup> Coetzee v ACS Financial Management and Cornelia S J Snyman, FAIS 00943/10-11 GP1

<sup>105</sup> Blue Zone Investments, Sharemax Investments and RVAF

<sup>106</sup> Elizabeth Maria Catharina Van Schalkwyk v Investiplan (PTY) Ltd (and another) FAIS 04143/12-13/GP 1 (page 7 par 23.6); Gert Corneulis Johannes Van Vuuren (and another) v Kampstone Financial Services CC FAIS 02156-09/10 GP(1) (page 10 par 13)

## 11. The differences between the interpretation of risk, with particular reference to the interpretation of risk by the FAIS Ombud

According to Profile's Unit Trusts & Collective Investments, March 2015, there is no definition of risk and no one answer to the problem of managing risk.<sup>107</sup> Perhaps the problem is that there are too many definitions of risk, because every stakeholder in the investment value chain, including the Regulator and the FAIS Ombud, have their own perspective on risk and investors are the ones caught up in the middle. What follows is an illustration of the various perspectives:



### 11.1 *The client*

Financial loss lies at the heart of 99% of client complaints and broken advisor-client relationships. Losing money is the investor's number one concern from a risk perspective. According to the South African Financial Planning Handbook it is more accurate to think of investors as being loss averse rather than risk averse. Poor returns will be forgiven provided that there is no actual capital loss.<sup>108</sup> A client-centric industry should appreciate this fact and align its communication and disclosures with clients' reality.

*Financial risk can be described as the probability of experiencing an event that has a negative financial implication thus a loss.*<sup>109</sup>

However, the reader will see that, although investors are primarily concerned with financial loss, they should actually be concerned with much more than just that if they want to achieve their objectives.

<sup>107</sup> Profile's Unit Trusts & Collective Investments, March 2015, p 96

<sup>108</sup> The South African Financial Planning Handbook (2014), page 364

<sup>109</sup> Investment Management, Johan Marx - Editor, Raphael Mpofu, Gerhard van de Venter, André Nortjé, Van Schaik Publishers (2006), Page 7

## 11.2 *The FSP (Firm)*

The financial services provider (firm) in South Africa is concerned about the risk it assumes by employing advisors who are interacting individually with clients. If an advisor (their representatives) do not follow an approved approach, they (the business) will ultimately be held accountable for any act of non-compliance by its representatives. This is called “advice risk” – the risk a firm assumes when their representatives (advisors) provide advice to clients. Advice risk is a business risk and as a result, financial services providers often select a risk profile questionnaire that they prescribe to their representatives, which actually leads the investor into one of its preferred investment products. Unfortunately, if the firm’s representative uses the risk profile questionnaire as prescribed by the firm, the representative will also be held accountable in the event that the FAIS Ombud finds against the advisor.<sup>110</sup>

## 11.3 *The advisor (representative)*

The firm’s representative (the advisor), as a professional investment advisor has to consider a number of risks when he or she provides advice to investors. The advisor, as a professional, has to consider the following *essential* risks from a financial planning point of view:

### 11.3.1 *Inflation risk*

Any professional financial planner simply has to pay due regard to inflation over the medium to long term when providing investment advice to clients. Whilst investors may decide to keep all their money in the bank and earn a market related interest rate, inflation will eventually destroy its purchasing power. Although loss of capital may be regarded as any investor’s biggest risk, losing money in real terms over the medium to long term is also a very real risk. To comply with section 2 of the Code of Conduct, any professional investment advisor must highlight inflation risk to his/her clients.

### 11.3.2 *Client needs and objectives and the risk required to achieve those needs and objectives*

Risk required is the risk associated with the (investment) return that is required to achieve the individual's goals from the resources available. A cash flow projection can quantify the return required to enable a client to achieve his/her objectives. In order to achieve a required return of CPI plus 3% p.a. over a 3 year period for example, one has to accept a required risk of -6,72% over any 12 month rolling period.<sup>111</sup>

### 11.3.3 *Risk capacity*

In his award-winning paper on risk capacity the author, Shawn Brayman, defined risk capacity as how much risk the client can afford - but what does that mean? First, he writes, the concept “afford to take” means we have a specific goal in mind to provide context. According to Brayman it is not possible to measure “afford to take” unless we have this. In his study he referred to a guidance paper by the FSA in the United Kingdom to provide more clarity:

*By ‘capacity for loss’ we refer to the customer’s ability to absorb falls in the value of their investment. If any loss of capital would have a materially detrimental effect on their standard of living, this should be taken into account in assessing the risk that they are able to take.<sup>112</sup>*

<sup>110</sup> Black v John Alexander Moore and Johnsure Investments CC

<sup>111</sup> Morningstar guideline for the period 01/01/2003 - 31/01/2016

<sup>112</sup> Defining and Measuring Risk Capacity by Shawn Brayman (2011), page 2

#### 11.3.4 *Risk tolerance*

Risk tolerance is the individual's general willingness to take financial risk. It is a psychological trait. According to the South African Financial Planning Handbook, generally, financial planners will find that a client's tolerance for risk is lower than the client thinks. When confronted by the stark reality of declining collective investment scheme prices in the second half of 1998, many investors were no longer willing to accept that, in the long term, equities outperform all other conventional investments. Sound long term strategies were scrapped in order to prevent further losses.<sup>113</sup> This supports my submission that when decisions are made, clients tend to look at possible returns, but when they start losing money, their focus turn to the risks.

#### 11.3.5 *Chance of loss*

Logically, when they provide financial advice, any professional financial planner should be concerned about the possibility of investors losing their money. In every reported case that I analysed where the investment scheme collapsed and the client lost money, the FAIS Ombud found against the advisor based on the advisor's duty to do a proper due diligence on the recommended financial product.

### 11.4 *Product supplier A*

This is risk from some product suppliers' perspective:

Risk is the uncertainty about whether an investment will earn its expected rate of return. Risk may also be viewed as uncertainty about future outcomes or the probability of an adverse outcome.<sup>114</sup> The standard deviation is a measure of total risk. It measures how "tightly" the probability distribution is centred around the expected value.<sup>115</sup> Once we have measured the expected return of an asset, we can define risk as the probability of the deviation (or variation) from the expected return. Risk would then be seen as the uncertainty of the mean return's ability to predict the actual future return.<sup>116</sup>

The volatility (frequency of price return movements) is an important measure of risk and can be expressed as the standard deviation of the expected return or price of investment.<sup>117</sup>

Examples of absolute risk objectives are a specified level of standard deviation or variance of total return. The variance of a random variable is the expected value of squared deviations from the random variable's mean. Variance is often referred to as *volatility*. Standard deviation is the positive square root of variance. An example of a relative risk objective is a specified level of tracking risk.

Seriously, what does all this mean to the average investor? Yes, intellectuals and academia will have wonderful debates over these concepts, but industry stakeholders must remember that explaining these concepts in clear and simple terms is a regulatory requirement. If clients do not understand it, the advisor is the only person who will ultimately pay the price.

<sup>113</sup> The South African Financial Planning Handbook 2014; LexisNexis, M Botha, L Rossini, W Geach, B Goodall, L du Preez, P Rabenowitz), page 364

<sup>114</sup> Investment Management, Johan Marx - Editor, Raphael Mpofu, Gerhard van de Venter, André Nortjé, Van Schaik Publishers (2006), Page 7

<sup>115</sup> Investment Management, Johan Marx - Editor, Raphael Mpofu, Gerhard van de Venter, André Nortjé, Van Schaik Publishers (2006), Page 8

<sup>116</sup> Investment Management, Johan Marx - Editor, Raphael Mpofu, Gerhard van de Venter, André Nortjé, Van Schaik Publishers (2006), Page 249

<sup>117</sup> Understanding Financial Markets and Instruments, Braam van den Berg, published by Eagle Rock Financial Services CC, page 54

### 11.5 **Product supplier B – Supporters of the life cycle theory**

Even product suppliers have philosophical differences in their approach to investing and how they are trying to address the issue of risk. Supporters of the life cycle theory believe that the older one gets, the less growth assets (equity exposure) you should have. From my analysis of the FAIS Ombud determinations, it would appear that the Ombud's Office leans towards this approach. In some of their correspondence to advisors and determinations the FAIS Ombud stated that, given the client's age, by definition the client is *conservative*. If the FAIS Ombud's Office follows this approach, whether it is intentionally or not, it holds serious implications for the financial planning profession.

*One of the most common intuitive heuristic beliefs according to the life cycle theory is that as individual's age, they are assumed to become less risk tolerant in all aspects of risk taking and therefore invest less of their portfolio in equities and more in fixed income securities. From a financial risk viewpoint, the foundation for this belief is that older investors have less expected time available to recover from potential losses incurred by riskier assets such as equities. This has always been a very popular perception among financial planners and has spawned fashionable and often convenient advice such as recommending that an individual's investment portfolio should contain a percentage of equity equal to 100 minus his age.<sup>118</sup>*

This philosophy is fundamentally different from the cash flow model used by many astute and award-winning financial planners.

### 11.6 **Market commentators**

The media writes about people who lost money through poor advice and fraudulent Ponzi schemes. Ponzi schemes and unscrupulous advisors usually go hand in hand and the media tends to refer to risk as "the loss of capital".

### 11.7 **The FAIS Ombud**

To understand how the FAIS Ombud interprets risk it is important to look at two definitions in the FAIS Act.

Section 20(3) of the Act states that the objective of the Ombud is to consider and dispose of complaints ...

A complaint is defined as a specific complaint relating to a financial service rendered by a financial services provider or representative to the complainant on or after the date of commencement of this Act, and in which complaint it is *alleged* that the provider or representative -

- (a) *has contravened or failed to comply with a provision of this Act and that as a result thereof the complainant has suffered or is likely to suffer financial prejudice or damage (loss)<sup>119</sup>;*
- (b) *has wilfully or negligently rendered a financial service to the complainant which has caused prejudice or damage (loss)<sup>120</sup> to the complainant or which is likely to result in such prejudice or damage; or*
- (c) *has treated the complainant unfairly;*

<sup>118</sup> Investment Management, Johan Marx - Editor, Raphael Mpofo, Gerhard van de Venter, André Nortjé, Van Schaik Publishers (2006), Page 244

<sup>119</sup> Thesaurus UK (My insert)

<sup>120</sup> Thesaurus UK (My insert)

## 12. A proposed definition of risk from an investment advice perspective, in view of the interpretation of risk by the FAIS Ombud

*Financial risk can be described as the probability of experiencing an event that has a negative financial implication, thus a loss.*<sup>121</sup>

## 13. Possible unintended consequences for advisors and investors in view of the interpretation of “risk profile” by the FAIS Ombud

- 13.1 Advisors may default to the life-cycle investment philosophy, which implies that the older a person gets, his/her exposure to growth assets will reduce, regardless of the investor’s time horizon, required return or whether growth assets offer the best value relative to other asset classes at the time or not.
- 13.2 Advisors may default to the client’s risk tolerance and invest the client’s funds too conservatively out of fear that the FAIS Ombud will assume that the client’s risk tolerance is the determining factor when it comes to suitability instead of considering all the components of the client’s risk profile (required risk, risk capacity and risk tolerance) and needs.<sup>122</sup>
- 13.3 Advisors may ultimately neglect the client’s real needs and objectives in favour of clients’ risk tolerance.

## 14. The need to establish a sound, fundamental framework for suitability of advice in respect of investments and investment products

There are many ways to highlight a serious problem. One way to do so is to make up a list of all the problems that different countries have recorded, separate from one another, and see if there are any common trends. What follows is an executive summary of the FAIS Ombud’s report and 3 other international papers or Notices offering more than 20 reasons why risk profiling should be of primary concern for financial planning professionals in South Africa:

- 14.1 *The know-your-client (KYC), know-your-product (KYP) and suitability obligations are among the most fundamental obligations owed by registrants to their clients and are cornerstones of our investor protection regime.* Staff from the Canadian Securities Administrators (CSA staff or we) assess registrants’ compliance with these important regulatory requirements as part of our compliance oversight reviews.<sup>123</sup>

I predict that the Financial Services Board will in the very near future introduce a much more intentional focus on suitability and risk profiling in particular.

- 14.2 *Risk profiling is an integral part of suitability of investment advice as required by law.*<sup>124</sup>

The General Code of Conduct prescribes compliance in accordance with the suitability requirements in section 8 as explained earlier.

<sup>121</sup> Investment Management, Johan Marx - Editor, Raphael Mpofu, Gerhard van de Venter, André Nortjé, Van Schaik Publishers (2006), Page 7

<sup>122</sup> As prescribed in section 8(1)(c) of the General Code of Conduct

<sup>123</sup> CSA Staff Notice 31-336- Guidance for Portfolio Managers, Exempt Market Dealers and Other Registrants on the Know-Your-Client, Know-Your-Product and Suitability Obligations (2014), OSCB 401

<sup>124</sup> Section 8(1)(c) of the FAIS General Code of Conduct

- 14.3** *Most of the (risk profiling)<sup>125</sup> questionnaires (83.3%) in use by the industry are not fit for purpose - they have too few questions, poorly worded or confusing questions, arbitrary scoring models, merge multiple factors (75%) without clarity or have outright poor scoring models.<sup>126</sup>*

If my initial analysis of risk profiling questionnaires in South Africa is any indication, a much higher percentage than 83,3% of risk profiling questionnaires are fundamentally flawed and not fit for purpose for very much the same reasons.

- 14.4** *There is a confusing and universal lack of existence or consistency of the definitions of risk concepts and a lack of understanding of the factors involved in risk profiling.<sup>127</sup>*

This problem was also highlighted in the Industry White Paper on Risk profiling (2014). This appears to be an international dilemma.

- 14.5** *Risk is not disclosed in clear unambiguous language.<sup>128</sup>*

In my opinion the FAIS Ombud is one hundred percent correct, as explained in this paper.

- 14.6** *Customer risk category descriptions are unclear or misleading.<sup>129</sup>*

As explained, and as the FIA and FPI surveys showed, categories such as conservative, moderate and aggressive are meaningless if the required risk and risk tolerance are not quantified.

- 14.7** *Many examples of descriptions have been found to be vague and do not effectively explain or differentiate levels of risk.<sup>130</sup>*

The same problem exists in South Africa, as highlighted in the FIA and FPI member surveys.

- 14.8** **Descriptions or illustrations do not clearly quantify the level of risk.<sup>131</sup>**

Again, in my opinion, the fact that descriptions do not clearly quantify the levels of risk is the single biggest contributor to all the confusion and problems that exist with regard to suitability. Much of the problems will be solved if the required risk, risk tolerance and risk capacity can be quantified. When these risks can be measured, financial advisors will be able to manage them much better.

- 14.9** *Many risk profile questionnaires are flawed because they do not determine investors' risk tolerance accurately.<sup>132</sup>*

<sup>125</sup> My insert

<sup>126</sup> Ontario Securities Commission Investor Advisory Panel Media Release (Nov 2015)

<sup>127</sup> Ontario Securities Commission Investor Advisory Panel Media Release (Nov 2015)

<sup>128</sup> FAIS Ombud Report 2012

<sup>129</sup> Ontario Securities Commission Investor Advisory Panel Media Release (Nov 2015)

<sup>130</sup> FSA Report March 2011, page 4

<sup>131</sup> FSA Report March 2011, page 16

<sup>132</sup> FAIS Ombud Report 2012

Again, much of the problems will be solved if risk tolerance can be quantified.

**14.10** *Some firms unduly focus on the risk a customer is willing to take and fail to take sufficient account of the customer's needs, objectives and circumstances.*<sup>133</sup>

With all due respect to the Office of the FAIS Ombud, from the analysis of the determinations it appears that the Ombud, with the benefit of hindsight, unduly focus on the risk investors are willing to take and fail to take into account investor's *objectives* when they made the investments, as some investors are partly to blame for focussing on achieving higher returns when making investment decisions. In the Ombud's defence, when this was the case, advisors generally could not provide the right evidence to support their version and as a result the FAIS Ombud had no other choice but to find in favour of the client.

**14.11** *Risk profile questionnaires can be interpreted in several ways.*<sup>134</sup>

In my opinion the FAIS Ombud is one hundred percent correct. As highlighted in this paper, as long as the different components of risk are not objectively quantified, there will always be room for subjective interpretation.

**14.12** *Flaws in questionnaires can lead to inappropriate conflation or interpretation of customer responses.*<sup>135</sup>

This appears to be an international dilemma and it is particularly relevant in South Africa.

**14.13** *Risk profile questionnaires are not always relevant to the investment at hand.*<sup>136</sup>

This is a common trend in South Africa, it contributes to the confusion and it distorts the outcomes of these questionnaires.<sup>137</sup>

**14.14** *Questionnaires use poor questions and answer options and have over-sensitive scoring or attribute inappropriate weighting to answers.*<sup>138</sup>

This appears to be an international dilemma and my initial analysis indicate that the combination of poor and/or irrelevant questions and inappropriate weighting to answers exacerbates the process even further.

**14.15** *Even where the risk profile has been correctly assessed, the product or portfolio does not always match this profile.*<sup>139</sup>

<sup>133</sup> FSA Report March 2011, page 4

<sup>134</sup> FAIS Ombud Report 2012

<sup>135</sup> Ontario Securities Commission Investor Advisory Panel Media Release (Nov 2015)

<sup>136</sup> FAIS Ombud Report 2012

<sup>137</sup> See the questions in the Profile's Unit Trust and Collective Investments Manual 2016, page 116

<sup>138</sup> FSA Report March 2011, page 3

<sup>139</sup> FSA Report March 2011, page 4

This was evident from some of the investors who indicated that they are aggressive investors, but their money was invested in an investment product that was later described by the FAIS Ombud as a Ponzi scheme.

- 14.16** *Description of the investment strategy is inconsistent with most customers' understanding of the risk posed by the category description, i.e. cautious.<sup>140</sup>*

This problem was confirmed by the FIA and FPI member survey results where it was clear that categories such as conservative, moderate or aggressive have different meanings to different people. Again, if these categories are not quantified, people will always struggle to understand it and it will always be open for interpretation.

- 14.17** *Almost all regulators surveyed are principles-based and provide little guidance on how a firm or advisor should arrive at the determination of a risk profile.<sup>141</sup>*

In their defence, I am sure that Regulators expected the industry to provide sound guidelines to their advisors. In my opinion, the financial planning profession should not wait for the Regulator to provide sound guidelines, but take responsibility ourselves to solve this problem. However, I do foresee that the Financial Services Board will ultimately follow its international counterparts in this area and follow the approach of the FCA in the UK by conducting an audit on risk profiling questionnaires used by various financial services providers and product suppliers.

- 14.18** *They (regulators)<sup>142</sup> all recognize and rely on the professional judgment of the advisor and the 'process' created by the advisor or firm to determine a consumer's risk profile.<sup>143</sup>*

Financial planning is not a perfect science and there will always be room for the professional judgement of the financial planner or advisor.

- 14.19** *No regulator provides clear guidance on how to combine the multiple factors and form a client risk profile.<sup>144</sup>*

As international studies continue to highlight the problems that currently exist, I am convinced that we will see regulators providing more and more guidance as every study contributes to the enhancement of professionalism and the integrity of the financial services industry. I will not be surprised that, when South Africa has implemented TWIN PEAKS and RDR, the FSB's attention will move to risk profiling and be more prescriptive, as it is an area of primary concern internationally.

- 14.20** *Almost half of the firms reported that risk questionnaires were developed in-house and another 36% said that advisors could choose their own risk profiling methodology.<sup>145</sup>*

<sup>140</sup> FSA Report March 2011, page 16

<sup>141</sup> Ontario Securities Commission Investor Advisory Panel Media Release (Nov 2015)

<sup>142</sup> My insert

<sup>143</sup> Ontario Securities Commission Investor Advisory Panel Media Release (Nov 2015)

<sup>144</sup> Ontario Securities Commission Investor Advisory Panel Media Release (Nov 2015)

<sup>145</sup> Ontario Securities Commission Investor Advisory Panel Media Release (Nov 2015)

In my opinion, the financial services industry is in need of a common framework for risk profiling, based on sound fundamentals. The fact that everyone chooses their own risk profiling methodology with all the flaws that go with it, as highlighted above, is part of the problem. It is a case of everyone playing the same game, but according to different rules. There needs to be some form of an industry standard.

**14.21** *Only 11% of firms could confirm that their questionnaires were ‘validated’ in some way.*<sup>146</sup>

At the moment, the only validation (or not) that is available to financial planners in South Africa is the FAIS Ombud. Unfortunately the Ombud has already revealed in their 2012 annual report that they are aware of the flaws in risk profiling questionnaires. From my analysis of FAIS Ombud determinations it is very clear that the Ombud will not easily validate a risk profile questionnaire. Therefore, I propose that financial planners should rather proactively review their risk profiling questionnaires and processes critically, before asking the FAIS Ombud to test it, because then it will in all probability be too late.

**15. The main components of an investor’s risk profile**

Understanding the risk profile of an investor is of fundamental importance because it lays the foundation for suitable advice. From all the literature and international guidelines referred to in this paper, I submit that an investor’s risk profile should be defined as the appropriate level of investment risk having regard to the investor’s required risk to achieve his financial objectives, and his capacity and tolerance to accept those risks.

**15.1** *Required risk*

*Risk required is the risk associated with the (investment) return that is required to achieve the individual's goals from the resources available.*

**15.2** *Risk capacity*

Risk capacity is the individual's ability to sustain worse than anticipated outcomes without severely compromising their goals. This refers to the individual’s capacity for loss.

**15.3** *Risk tolerance*

Risk tolerance is the individual's general willingness to accept the possibility that his/her investments may drop in value or result in a loss. It is a psychological trait.

## 16. How can providers ensure that they have considered all the components of an investor's risk profile in the advice process?

Earlier in the paper I referred to the fact that there are so many aspects to risk profiling that it may be necessary to apply the *Pareto-principle* (80/20 principle) to these components as there are essentials, good-to-haves and nice-to-have elements to every subject. In an attempt to simplify the concepts for the *average advisor and investor*, I am deliberately avoiding some of the complex, theoretical concepts in this paper.

### 16.1 Required risk

There is enough evidence that financial planners and advisors, as part of their suitability requirements, have to understand their clients' circumstances, needs and objectives to determine their required investment return in order to meet those objectives.<sup>147</sup> The best, if not the only way, to establish the required risk that an investor must take to achieve his or her financial goals is by means of a comprehensive cash flow analysis, taking into account the investable capital, current income, emergency funds, required future income, future capital expenses, an assumed inflation rate and a realistic assumed investment growth rate.

This cash flow projection will obviously not be perfect due to all kinds of variables, but after 26 years in the financial services industry I have not been introduced to a better way of quantifying the required return an investor needs to achieve his or her objectives. When an advisor knows what the investor's required return is to meet his or her objectives, only then is it possible to quantify the investor's required risk, because these concepts are inseparable. As a result, I support the notion that the primary point of departure for a professional financial planner would be to establish the return that is required to achieve his client's objective and to disclose to the client what the associated level of risk would be. If the client understands and is happy to accept the required risk associated with the required return and agrees to it in writing, it means that the second component, his risk tolerance was considered and agreed to. If the client does not want to accept the level of risk (chance of loss) associated with his required return then it gets more complicated.

### 16.2 Risk tolerance

Of all the components of risk profiling, risk tolerance is that one element that can cause the difference between success and failure in achieving the client's objectives as well as defending one's actions before the FAIS Ombud. It is often easier to affirm the way a client feels than it is to advise a client to do the things he does not feel like doing now, but both parties know that over the long term it will be in his/her best interest.

The tolerance of investors can often be compared to people going to the dentist. Every patient would prefer a general check-up without any surprises, like a comprehensive root canal treatment for example. However, in order to solve a root canal problem over the long term our patient actually does not have a choice. The root canal treatment is the right treatment to solve the problem and if the symptom is not treated, the problem gets worse and worse as time goes on. If the patient does not feel like taking the treatment, he or she will eventually have no choice but to take the professional treatment. Likewise, if clients do not feel like accepting the required risk and as advisors we are simply required to invest our client's money according to his feelings or tolerance for risk, it would

<sup>147</sup> See section 8(1)(a) of the General Code of Conduct, Financial Industry Regulatory Authority (UIS), Canadian Staff Notice 31-336

be like sending the patient who actually needs a full root canal treatment home with a Panado (pain pill) and still charge him the same fee. Would that be sound advice?

The harsh reality is that some advisors actually follow the path of least resistance, invest their clients' money according to how they "feel" about risk and charge the same fee as they would have charged if they had done a proper analysis. It ultimately is a trade-off between advising the client in accordance with his needs and objectives as required in terms of The FPI Code of Ethics and Professional Standards (2015) and the client accepts the risks or the client deciding not to accept the "root canal treatment" knowing that his pain (failing to achieve his long term needs) will increase as time goes on.

However, regardless of how one feels about the outcome, international regulators agree that the client's risk tolerance has to be considered and I accept that, without an understanding of the potential downside to any investment, no client would be able to make an informed decision. Therefore, risk tolerance should be the secondary risk consideration and the client will have to sign off on the fact that he does not want to invest his money to achieve his objectives, but prefers to invest according to his risk tolerance, which in most cases effectively means that he is guaranteed not to achieve his financial objectives. As no doctor can force a patient to follow his recommendations, no client can be forced to accept good advice. Whichever decision the client makes, the advisor must record the process and the ultimate decision (with reasons) accurately.<sup>148</sup>

### 16.3 Risk capacity

In its most basic form, advisors must ensure that there is sufficient cash and/or liquid investments available in a money market, fixed interest account or in a "low risk"<sup>149</sup> fund that can "buy enough time" for the investor to wait for his or her investments to recover when markets are under pressure. The risk that advisors want to prevent is that, due to some unforeseen event or cash flow constraints, an investor is forced to liquidate an investment portfolio at a time when the market value of his/her investments is reduced and the investor locks in a financial loss.

I am concerned that, in the absence of clear guidelines of how to calculate and quantify this component, risk capacity will be a concept that would be easy to judge with the benefit of hindsight. In the absence of an industry standard it is proposed that, as a basic requirement, advisors consider the following:

#### 16.3.1 *Current income*

Does the investor earn an income from other sources, such as a salary, consulting or rental income etc.? This answer will affect the amount that should be considered as an emergency fund.

#### 16.3.2 *An emergency fund*

Perhaps an emergency fund equivalent to six month's salary or required income could be considered as a rule of thumb. Again, this amount may differ depending on the investor's individual circumstances, but there must be a clear indication that risk capacity was considered in the planning process.

<sup>148</sup> Section 3(1)(e) of the General Code of Conduct and CSA Staff Notice 31-336 (2014) 37 OSCB 414

<sup>149</sup> Low risk is used in a general sense, which in this context means a portfolio that contains asset classes which are not subject to volatility like equities and property for example.

16.3.3 *Sufficient cash or low risk investment*

Risk capacity will in all probability become a real consideration in a bear market when clients may have to lock in losses when they are drawing from a portfolio that is declining in value. Then investors are forced to start selling more units in order to maintain their income level. After analysing the FAIS Ombud determinations, I believe that the Ombud would question a strategy where there is not sufficient liquidity or cash allocation from which income can be drawn in a bear market.

**17. A sound framework for the type of evidence that should be acceptable to the FAIS Ombud when trying to resolve complaints related to the suitability of investment advice**

In many determinations the Ombud highlights that no record of advice was maintained to explain why the selected product was likely to satisfy the client's identified needs and objectives. In the majority of FAIS Ombud cases the outcome ultimately depends on whether the facts and evidence support whether the advisor provided appropriate (suitable) advice. During a Retail Financial Services Africa Conference hosted by the *Institute for International Research* at the Hyatt Hotel in Rosebank on 30 March 2006, South Africa's first Ombud for Financial Services Providers, the late Mr. Charles Pillai made a significant statement. He said:

- ✓ *Cases are won or lost based on facts.*
- ✓ *If we have the right evidence, chances are slim for us to find against the financial services provider.*
- ✓ *Poor record-keeping is at the centre of our determinations.*

After ten years this is still the case as Assistant Ombud David Davidson gave financial services providers a 3 out of 10 mark for record-keeping at the 2014 Insurance Conference at Sun City.

The following written evidence are proposed:

- 17.1 Written evidence of the client's needs and objectives
- 17.2 Written evidence of the client's required return and associated required risk
- 17.3 Written evidence of the client's investment term
- 17.4 Written evidence of the client's willingness to accept the required risk as highlighted by the advisor in order to meet the client's stated objectives over the agreed term
- 17.5 Written evidence that the risk capacity (emergency fund & sufficient liquidity) was considered
- 17.6 A written agreement between the advisor and client in respect of the suitability of advice

## **18. Proposals to the financial services industry to react proactively in view of the risk profiling developments internationally, before the Regulator is forced to introduce further rules and regulations**

- 18.1** The Financial Planning Institute of Southern Africa and/or The Financial Intermediaries Association of Southern Africa should commission a workgroup, similar to the Investor Advisory Panel, the independent committee of the Ontario Securities Commission in Canada, to establish an international best practice standard for risk profiling in South Africa with the objective of:
- 18.1.1 Providing a sound, common framework for risk profiling for the financial planning profession;
  - 18.1.2 Setting a standard for risk profiling that will satisfy the FAIS Ombud so that financial planners / advisors will be able to use the guidelines with confidence; and
  - 18.1.3 Ultimately serving the best interests of investors.
- 18.2** The FAIS Ombud determinations imply that risk capacity and risk tolerance are the most important factors to consider when providing investment advice. It is proposed that a stronger focus be placed on the needs and objectives of the client.
- 18.3** It must be recognised that the questionnaire is just one component of determining an investor's risk profile. What is of importance is that there has to be evidence that the advisor engaged in discussions with the client to reach a final agreement on a risk profile. The ultimately agreed to profile could easily be inconsistent with the results of any risk profile questionnaire, subject to the agreement and/or record of advice reflecting the reasons for such inconsistency.
- 18.4** The final risk profile agreement should outweigh any results from any risk profiling questionnaire.
- 18.5** The Financial Ombud Service recognises that skilled advisors can secure their clients' informed consent without using risk profiling tools.
- 18.6** Regardless of whether risk profiling tools are used or not, FSPs must keep detailed records that show they secured their clients' informed consent about the level of risk required to achieve objectives. Without these records, FSPs have greater difficulty defending claims involving the adequacy of their risk profiling practices and procedures. The statement "the level of risk required to achieve their objectives is an important recognition by the Regulator that investing cannot be considered separately from a client's goal.
- 18.7** In the event that the Financial Planning Institute of Southern Africa and/or The Financial Intermediaries Association of Southern Africa do not commission a workgroup as proposed, it is recommended that the Regulator, like the Ontario Securities Commission in Canada, commission such a workgroup.
- 18.8** In the event that the industry bodies or the financial services industry fail to establish a new, acceptable standard for risk profiling, the Regulator may have to consider incorporating "fit for purpose" guidelines when referring to risk profiling questionnaires, like in India for example, where the Securities and Exchange Board of India requires that firms have a process for assessing the risk a client is willing and able to take, including:

- 18.8.1 Assessing a client's capacity for absorbing loss;
- 18.8.2 Identifying whether the client is unwilling or unable to accept the risk of loss of capital;
- 18.8.3 Appropriately interpreting clients' responses to questions and not attributing inappropriate weight to certain answers;
- 18.8.4 Where tools are used for risk profiling, it should be ensured that the tools are fit for purpose and any limitations are identified and mitigated;
- 18.8.5 Any questions or descriptions in any questionnaires used to establish the risk a client is willing and able to take are fair, clear and not misleading;
- 18.8.6 It should ensure that:
  - 18.8.6.1 Questionnaires are not vague or use double negatives or in a complex language that the client may not understand;
  - 18.8.6.2 The questionnaire is not structured in a way that contains leading questions; and
  - 18.8.6.3 The risk profile of a client is communicated to the client after risk assessment is done.<sup>150</sup>

### **In closing**

Thank you for taking the time to read through this paper. If you have made the effort to read the entire paper, I suspect that you have a keen interest in this topic. You are welcome to submit your comments, constructive criticism and suggestions to [anton@amitywealth.co.za](mailto:anton@amitywealth.co.za) if you wish to add your voice to the risk profiling debate. Solving the risk profiling dilemma calls for collaborative effort by dedicated individuals internationally who passionately pursue those fundamentals that will lay a sound foundation for providing suitable advice.

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<sup>150</sup> See the Securities and Exchange Board of India (SEBI, 2003), page 10