

**INVESTMENT MANAGEMENT RISK ASSESSMENT:
MARKETING AND SELLING PRACTICES**



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1. Introduction

- 1.1 The Technical Committee at its meeting in October 2002 approved publication of the paper entitled “Investment Management: Areas of Regulatory Concern and Risk Assessment Methods,” designed to help develop a common view of the risks that collective investment scheme operators (“CIS operators”) pose to the achievement of regulatory objectives and of the relative importance of those risks.
- 1.2 The paper divided the risks into two types, namely, inherent business risks and control risks. Each risk type had a number of risk factors that needed to be taken into account when assessing the overall risk profile of a CIS operator, namely:-

Inherent Risks

- 1.2.1 Consumer and Product Type.
- 1.2.2 Business Strategy.
- 1.2.3 Financial Viability.

Control Risk

- 1.2.4 Managerial.
 - 1.2.5 Organisational.
 - 1.2.6 Operational.
 - 1.2.7 Marketing and Selling Practices.
 - 1.2.8 Complaints by Investors.
 - 1.2.9 Regulatory History.
- 1.3 This paper is designed to describe the details of the relevant risk factors associated with the marketing and selling practices of a CIS operator (see 1.2.7 above); what information should be taken into account by the regulator in assessing those particular risks in the CIS operator; and lastly the responses to those risks by both the regulator and their expectations of the CIS operator in controlling those risks.
- 1.4 Investment in a CIS, like any investment, carries with it certain risks (e.g. interest rate risk, currency exchange risk etc). In order to make an informed investment decision an investor who is contemplating investment in a CIS needs to understand both the potential rewards and associated risks.

2. Detailed description of the Marketing Risk factors

- 2.1 The marketing risk, as viewed by the regulator, is that either by mismanagement or by misconduct in the marketing and selling processes the CIS operator will cause consumer loss and thereby possibly, lead to a damaging of confidence in the financial system or to liabilities for damages (from consumer or regulatory fine) followed by solvency problems for the CIS operator. For regulators, there is a further concern that

inadequate understanding by consumers of a CIS will lead to an inappropriate/ill-informed investment decision by the investor thereby causing investor loss.

- 2.2 It is, however, not the intention of this paper to describe the various consumer education initiatives by both regulator and CIS operator and thus this paper will concentrate on misconduct/mismanagement in the marketing and selling processes by firms as the primary risk issue. However IOSCO SC5 has carried out a study of the various initiatives implemented by members in the important area of consumer awareness and reference should be made to that paper to understand better how regulators have, in part, tackled the issue of misleading/inappropriate marketing by educating the consumer.

3. Identification of the Marketing Risk Issues

- 3.1 Although there are generic risk issues concerning marketing and selling practices of CIS it is necessary to distinguish the two main distribution channels for selling CIS products, i.e., **direct offer** and through **intermediaries**. Each type of distribution channel will pose its own unique risks.

4. Direct offering of CIS products (Financial Promotion)

False/Misleading/Incorrect/Inappropriate financial promotion (by way of a direct advertising or by way of a prospectus) leads to direct investor loss, for which the investors could sue the CIS operator for damages or the regulator could impose a penalty, so that solvency problems could arise for the CIS operator, which is an indirect risk factor for investors, because in the case of solvency problems the CIS operator will not be able to pay for the damages. Also an insolvent CIS operator would be unable to provide ongoing adequate services to the CIS that in turn might lead to risk to existing investors. [Note: certain jurisdictions may have a compensation scheme that covers investors in the event of an insolvent manager].

4.1 Risk Indicators suggesting false/misleading financial promotion

- (a) CIS operator has inadequate advertisement vetting procedures.

The CIS operator fails to have adequate systems and controls so as to prevent inappropriate financial promotion taking place.

- (b) CIS operator has a record of misleading adverts or is very creative in approach to promotion.

The regulator will have a view and maybe a detailed past history identifying the CIS operator as one which often breaches the advertising rules or is overly aggressive in its financial promotions. This could include aggressive cold calling and the offering of incentives such as gifts. Examples of evidence of a possible non-compliant or unduly risky CIS operator could be:

Product literature/advertising fails to meet legal/regulatory requirements
Product literature is out of date, inaccurate, incomplete or inappropriate
Disclosures and risk warnings are obscure or in very small print
Financial promotion on the internet allows customers to bypass warnings
Product description is poor and unclear (possibly masks fraudulent activity)

Past performance figures are exaggerated
Future return promises are unrealistic
Misleading product comparisons are made
Investment advice is poor, unclear or possibly fraudulent
Pressure selling techniques such as unsolicited telephone calls
Offering of incentives to buy that are not actually delivered
"Bait" advertising (advertising claims such as price that are unlikely to be delivered)

(c) Adverts target "vulnerable" groups

The CIS operators deliberately target those investors who are likely to be poorly educated or advised and hence are more likely to buy unsuitable products.

(d) High level of customer complaints

A high level of complaints could signify misleading adverts leading to investor loss.

(e) CIS operator has a weak system for tracking investor subscription

The potential here is that through poor systems and controls and/or incompetence, investor loss occurs at the subscription stage.

(f) CIS operator is using CIS assets for marketing the CIS (here the operator might have been extracting a charge from the CIS to promote his activities, such charge being over and above that standard charge levied by the operator) or if a jurisdiction permits CIS assets to be used for the financing of the distribution of its shares then this has been carried out without appropriate corporate oversight and/ or has been carried out without adequate disclosure.

Misuse of CIS assets could lead to compensation payable by the CIS operator.

(g) CIS operator has a large advertising budget and is aggressive

A CIS operator with a large advertising budget and an aggressive approach to financial promotion could lead to exaggerated promotional claims and hence misleading adverts.

5. Indirect offering of CIS products (Use of intermediaries)

CIS products are mis-sold to investors and mismanagement of the relationship to the intermediaries leading to mis-selling claims which in turn lead to solvency problems for the CIS operator (note again that the consumer awareness issues have not been addressed here).

5.1 Risk Indicators suggesting mis-selling by intermediaries

(a) Inadequate training and assessment of competency of sales force

The sales force does not understand the products being sold and hence fail to alert investors to the risk issues.

(b) Salesmen rewarded by commission and set aggressive sales targets

The salesman could be incentivised to sell products that are unsuitable for the customer.

- (c) Aggressive selling techniques adopted
Here sales targets drive the salesman and this could lead to mis-selling.
- (d) High level of customer complaints
This could signify a number of issues such as aggressive sales techniques, poor performing products or products that have been mis-sold.
- (e) High level of sales force turnover
High levels of sales force turnover may indicate over ambitious sales targets.
- (f) Rapid growth of sales, which might lead to strains on systems, rapid take-on of inexperienced salesmen
Inexperienced salesmen could lead to a future claim for mis-selling.
- (g) Sales targets start being missed might lead to desperate attempts to boost sales
As with b) and c) above.
- (h) Unusual sales force incentive structures, e.g. transfer payments of certain excessive amounts of the management fees to the intermediaries biased by the mediated volume of units on a currently repeated basis (reward heavily biased towards volume of products sold)
This again could be another indicator of a sales force that is incentivised to sell as much product as possible possibly to the detriment of the suitability for customer.
- (i) Inadequate control over the salesmen and their practices
Weak controls over period of time could lead to high compensation claims and hence possible solvency issues for the CIS operator.

6. Assessment of the Marketing Risk

- 6.1 Before any regulatory assessment of the risk issues can be made an initial assessment of the business operating environment needs to be made. For instance have the legal and political conditions for CIS operators changed e.g. an introduction of more stringent advertising rules; has the economic climate changed e.g. in weak equity markets investors switch to fixed interest products; has the competitive environment changed e.g. many new CIS operators have appeared in the market place; have changes in technology impacted on CIS operators e.g. more internet based offerings.
- 6.2 This initial assessments needs to be made by the regulator in order to place the marketing and selling practice risks in context, and of course this assessment is likely to vary from country to country. Finally this assessment will also give regulators a clue as to whether marketing issues should be top of their priority lists i.e. in strong equity markets, mutual funds will be considered attractive and thus marketing efforts by CIS operators are likely to be on the increase. However, possibly in more bearish markets, the marketing efforts of CIS operators might become more "imaginative."

Having placed the marketing issues in context the regulator has two main methods of monitoring marketing issues – remotely or by inspection visits (possibly carried out by a third party) to the CIS operator.

7. Remote Monitoring by the regulator of marketing by the CIS operator

7.1 Below is set out a list of questions a regulator might pose when considering the marketing issues at a CIS operator. It is not intended that this list be totally comprehensive or exhaustive, but more a brief guide. It is also assumed that the regulator can access material such as adverts, promotional literature, etc., fairly easily and at little cost. The questions are designed to clarify the procedures in the CIS operator as well as attempting to highlight unusual practices and trends. These will put the regulator on enquiry when supervising the particular CIS operator. Certain regulators may approve all prospectuses/promotional literature.

- (i) Does the regulator as a matter of routine sample check adverts in the national and trade press or sample check prospectuses/promotional literature? (It is possible in some jurisdictions that other regulatory bodies are responsible for the review of advertising material). Does this review also cover any advertising by the intermediary of the CIS?
- (ii) Is the advertising by the CIS operator or intermediary show any trends? Exaggerated claims of past performance? Poor risk warnings?
- (iii) How clear is the advertising? Does it promote product understanding, highlight important information and consider the customer needs?
- (iv) Are certain CIS operators and/or intermediaries appearing more than others? And are certain CIS operators and/or intermediaries known for “cutting corners” with their literature (such operators might be known by the regulator to have a poor understanding of the rules)?
These questions are designed so as to increase the monitoring of those operators/intermediaries by the regulator.
- (v) Are incorrect product comparisons being made? This would suggest a CIS operator/intermediary is trying to exaggerate the product's performance
- (vi) Are specialised CIS being offered that seem unusual in the current climate? Again this must raise a question in the regulator's mind as to why the CIS operator/intermediary is confident of the product's success even though the market conditions suggest otherwise.
- (vii) Does the advertised CIS product make "sense" when the CIS operator is identified? For instance a CIS operator with no experience in a particular market would not normally be expected to launch new funds in those markets. Likewise with the intermediary promoting CIS shares outside his "normal" market.
- (viii) Are all forms of advertisement covered e.g. radio, internet? It is important that the regulator covers all forms of product promotion.
- (ix) Can internet offerings be purchased without the customer viewing the risk warnings?
- (x) Does the regulator monitor customer complaints? Does the CIS operator have to inform the regulator of the complaints it receives and has resolved or those that remain unresolved? If complaints arise from the action of intermediaries does this highlight poor training of staff?

- (xi) Do the CIS returns appear unnaturally successful? This could highlight those CIS operators that are not following the market trend and the regulator should establish why this is.
- (xii) Is there a high turnover of sales staff?
- (xiii) Are there unusual inducements offered to the intermediaries by the operator, e.g. transfer payments from the management fees biased by the mediated unit volume on a currently repeated basis (in other words rewards for intermediaries heavily biased towards volume of sales)?

8. Inspection visits to a CIS operator

8.1 On an inspection visit to a CIS operator it is assumed that the regulator has full access to all relevant records such as management accounts, internal audit reports etc.

8.1.1 Advertising/ Promotional literature/Prospectus review

- (i) Does the firm have an advertising policy? How is this policed and reviewed?
- (ii) Are there approved procedures? [Ensure approval by an authorised person or entity].
- (iii) How is compliance with legal/regulatory obligations checked?
- (iv) Do the advertising staff understand CIS products and thus appreciate how to describe the risks? Similarly does the CIS operator seek legal advice regarding the drafting of its literature?
- (v) Are complaints recorded, followed up and satisfactorily dealt with? Are trends identified?
- (vi) Is the level of complaints unusual for the industry?
- (vii) Is the language used clear and unambiguous?
- (viii) How is the material made available to investors?
- (ix) How are cancellations dealt with?
- (x) Are unusual incentive payments offered by the operator?

8.1.2 Sales Force review

- (i) What are the procedures for recruitment? Are proper references taken up? How is competency assessed at the interview?
- (ii) What are the training procedures adopted by the operator?
- (iii) How are the training needs assessed?
- (iv) What are the on-going evaluation procedures?
- (v) Is there a regular assessment of competence? Examinations? Both conducted by the CIS operator? Does the CIS operator have appropriate measures in place to ensure that the sales force are adequately supervised, monitored and trained and have satisfactory organisational expertise?
- (vi) Does training conducted or supervised by the CIS operator cover technical skills as well as legal and regulatory obligations?
- (vii) Does the CIS operator have an active, organised and focussed compliance/internal audit regime covering the sales force activities including that done by intermediaries/and their on-going competency)?
- (viii) Are complaints against the sales force monitored and followed up by the CIS operator?

- (ix) Are there unusual inducements offered to the sellers by the operator, e.g. transfer payments from the management fees biased by the mediated unit volume on a currently repeated basis (in other words rewards for salesmen heavily biased towards volume of sales)?

9. Expectations of CIS operators and their controls over the marketing and selling practice risks

9.1 As demonstrated in the above a CIS operator needs to employ strict procedures and controls around their marketing and selling activities if they are to avoid mis-selling possibilities. Operators will also wish to have sound procedures in place to avoid errors and omissions that might cause them reputational problems and possible liabilities for damages covering both own marketing activities and such of third parties.

9.2 CIS operators as a minimum should have the following in place:

- (a) A sound set of procedures and controls concerning their advertising. Such work should be carried out by competent staff and be reviewed by an independent and capable review team. Procedures should encompass all legal and regulatory requirements as well as ensure any promotional literature is fair, clear and not misleading.
- (b) Similarly there needs to be procedures in place to ensure that any prospectus or promotional material is legal. This might require the assistance of external experts e.g. lawyers.
- (c) A sound and clear set of procedures and controls regarding the recruitment and on-going training of sales forces.
- (d) Systems and controls regarding the recording and handling of complaints. Trends should be identified and a clear and appropriate remedial programme should be instituted.
- (e) An independent review function should be operating that is aware of current legal and regulatory developments.

10. Controlling marketing and selling risk

The regulator has several tools at his disposal, which could assist in control of marketing risk. Examples are:

10.1 Power to make specific Rules

Using its rule making powers the regulator could, for instance, prescribe matters to go into the advert (one regulator has drawn up "Good Disclosure Principles"), codify past performance presentation (please note here IOSCO SC5's work on CIS past performance presentation standards), insist on highlight risk issues, etc thereby requiring all issuers to follow a set format. This could mitigate against misleading

adverts. Such rules could also include training and competence standards of sales forces.

10.2 Prior Approval by the regulator of all adverts issued

Although time consuming, the regulator could require all adverts to be authorised by him. This would provide a quality and consistency check.

10.3 Powers to fine CIS Operators/ Powers to force withdrawal of adverts

The regulator should have the power to discipline that could lead to a fine and/or compensation that arises from any misleading advertising or mis-selling by a sales force. Other powers could include injunctions relating to certain conduct, stop orders for misleading adverts, orders to disclose certain information and orders to publish rectifying adverts.

10.4 Public statements

An ability by the regulator to issue public statements condoning poor practice or recommending higher standards from the CIS industry should have a powerful impact on the industry practitioners.

10.5 Codes of Conduct issued by trade bodies, etc

An active trade body that is keen to maintain high standards in the advertising of CIS products might consider issuing codes of conduct for the industry.