Assessing Suitability with regard to investment advice

Determining the financial needs of a customer and the risk the customer is willing and able to take when making suitable investment and financial product decisions.

The purpose of this report is to highlight the need for the financial services industry in South Africa to properly evaluate the use of risk profiling questionnaires by financial advisors and to establish a sound framework to quantify the risk investors are willing and able to take when making suitable investment and financial product decisions.

The Advisor's Risk Profiling Workgroup

Compiled by Anton Swanepoel

8/1/2014

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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 last, but by no means least, Mr. Geoff Davey, Cofounder and Director of FinaMetrica.

Assessing Suitability with regard to investment advice

1. Introduction

The introduction of the Financial Advisory and Intermediary Services Act, 37 of 2002 and its subordinate measures in South Africa in 2004 have highlighted a number of important issues pertaining to investment advice in particular, with which the financial services industry still appears to be struggling with, such as:

1. Defining and quantifying the customer's needs and / or objectives clearly;
2. Defining and quantifying risk in the context of providing investment advice to customers;
3. Defining and quantifying the risks that the customer is required to take in order to achieve his / her needs and/or objectives;
4. Defining and quantifying the risks that the customer can afford to take in order to achieve his/her needs and/or objectives;
5. Defining and quantifying the risks that the customer is willing to take;
6. Appropriate disclosures with regard to risk and the risk profile of funds;
7. Consistency in disclosures pertaining to risk and the risk profiles of all the different funds by industry stakeholders;
8. Relevant and material disclosures with regard to risk which will enable customers to make informed decisions;
9. Providing suitable advice and taking reasonable steps to ensure that a customer is in a position to understand the advice and to make informed investment and financial product decisions; and
10. Accurately recording the advice and subsequent transaction(s).

The concept of risk and the application of risk profiling in the advice process have been topics of much debate in the financial services industry. Over the years there have been numerous presentations and written articles published by industry experts on the topic. One of the more recent debates in search for the correct approach was hosted by the Financial Planning Institute of Southern Africa in the form of a panel discussion at the FPI National Convention on the 25th of June 2014.

At the outset the Advisor's Risk Profiling Workgroup agreed that the arguments contained in this paper must not be formulated simply to provide the industry with a tick-box compliance solution. Although the concept of risk and risk profile is contained in the FAIS General Code of Conduct, the Workgroup agreed that risk and risk profiling should not be a compliance issue, simply because it is a suitability issue. Without a proper understanding of a customer's risk profile and an understanding of the risk profile of a proposed investment fund or portfolio, no advisor would be in a position to give suitable advice and no customer would be in a position to make an informed investment decision. This means that, in order to give suitable advice, financial services providers must fully understand the needs and risk profile of the customer, as well as the risk profile of the proposed investment product.

It was agreed that the primary purpose of this paper would be to provide sound and well researched guidelines to financial services providers and other industry stakeholders to ultimately ensure that advice pertaining to investment products provided to customers is suitable. This paper aims to highlight the problems and flaws that currently exist with regard to commonly used risk profiling outcomes and to propose a risk profiling framework based on sound fundamentals, which will address the problems and serve future generations better.

It further aims to:

(i) highlight the significant problem advisors face when attempting to provide appropriate advice in accordance with the customer's needs and risk profile as required in terms of the FAIS General Code of Conduct;

(ii) highlight the obligations advisors have when providing advice with regard to investments and investment products;

(iii) offer guidelines to advisors when providing advice with regard to investments and investment products;

(iv) offer proposals to industry stakeholders to assist financial advisors and intermediaries to act in the best interest of customers;

(v) offer proposals with regard to sound and consistent interpretation of concepts such as risk and risk profile;

(vi) invite industry comment and proposals to eliminate the current flaws and inconsistencies with regard to the definition and quantification of risk and risk profile; and

(vii) establish an industry best practice standard framework in the provision of suitable advice.

2. Concerns raised by the FAIS Ombud

There has been much confusion and dissatisfaction with regard to risk profiling models in South Africa over the years. Some advisors have publicly stated that risk profiling as applied by the industry is nonsense[1] and others have stated that the only reason they have a document titled risk profile in their file is to satisfy their compliance officer. The confusion and dissatisfaction is also evident from a number of FAIS Ombud Determinations[2] and in particular the FAIS Ombud's Annual Report of October 2012 where it was stated:

> *The Ombud's office frequently encounters a <u>disconnect</u> between a complainant's <u>risk tolerance</u>, as calculated according to <u>questions</u> laid out in a <u>risk profile document</u> and the complainant's actual circumstances. Risk profile questionnaires can be <u>interpreted</u> in several ways and are not always <u>specific</u> or <u>relevant</u> to the investment at hand. Risk must be disclosed and in clear unambiguous language.*[3]

The Advisor's Risk Profiling Workgroup is of the opinion that, if financial services providers do not fully appreciate these concerns expressed by the FAIS Ombud and take the necessary steps to address the problems identified by the Ombud's Office, financial services providers will continue to use risk profiling questionnaires that are fundamentally flawed. If providers continue with this practice, they will be instrumental to inappropriate advice to investors and as a result they will stay exposed to advice risk and be held accountable under FAIS, as is currently the case.

It is clear from the report that the FAIS Ombud's Office pay particular attention to the risk profiling tools that advisors use when they provide advice to customers and as a result providers should seriously consider all concerns expressed.

3. International research

The concept of risk and the application of risk profiling questionnaires is not only a South African problem. This is evident from a number of international studies and reports on the subject[4] of which some were published by regulators[5] in more developed countries since 2011.

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[1] Andrew Bradley, CEO of Old Mutual Wealth Management at the 2014 FPI National Conference

[2] Some examples include Black v John Alexander Moore FAIS 03984/09-10/EC1 and Chistoffel Andries Schutte v R&S Walsh Investment Consultants CC and others FAIS 03984/09-10/EC1

[3] Also reported in Money Marketing Article dated 31 December 2012

[4] E.g. The Society of Actuaries in Ireland Report 2011, FinaMetrica Paper (SA Version) 2012, CONSOB Discussion Paper July 2012, DNA Behavior International Report May 2013

[5] E.g. FSA Guidance Paper 2011

According to the Financial Services Authority (FSA)[6] report on assessing suitability, *Establishing the risk a customer is willing and able to take and making a suitable investment selection,* half of the files assessed between March 2008 and September 2010 were unsuitable on the grounds that the investment selection failed to meet the risk a customer was willing and able to take.[7]

Of the 366 cases that were judged to have failed the FSA's suitability requirements, 199 failed because the investment selection did not meet the customer's attitude to risk.[8] Eleven risk profiling tools and were reviewed and they expressed concern when they found that nine of these tools had weaknesses which could, in certain circumstances lead to flawed outputs.[9]

South African stakeholders will do well to consider some of the following key findings contained in the 2011 FSA Report as most, if not all, apply to our market as well:

1. Many firms fail to take appropriate account of their clients' capacity for loss.[10]
2. They expressed concern that questionnaires use poor questions and answer options and have over-sensitive scoring or attribute inappropriate weighting to answers[11]
3. Flaws in questionnaires can lead to inappropriate conflation or interpretation of customer responses[12]
4. Many examples of descriptions have been found to be vague and do not effectively explain or differentiate levels of risk.[13]
5. Even where the risk profile has been correctly assessed, the product or portfolio does not always match this profile.[14]
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.[15]
7. Customer risk category descriptions are unclear or misleading.[16]

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[6] Now known as the Financial Conduct Authority
[7] FSA Report March 2011, page 2
[8] FSA Report March 2011, page 7
[9] FSA Report March 2011, page 4
[10] FSA Report March 2011, page 3
[11] FSA Report March 2011, page 3
[12] FSA Report March 2011, page 3
[13] FSA Report March 2011, page 4
[14] FSA Report March 2011, page 4
[15] FSA Report March 2011, page 4
[16] FSA Report March 2011, page 16

8. Descriptions or illustrations do not clearly quantify the level of risk.[17]

9. Description of the investment strategy is inconsistent with most customers' understanding of the risk posed by the category description, i.e. cautious.[18]

The 2011 FSA Report has highlighted a problem and it is clear that this is a subject that needs to be addressed by industry stakeholders internationally. Some commentators even encourage regulators to get involved. According to an article by Neil Gross | March 31, 2014 published in a newsletter by FinaMetrica, the Canadian Foundation for Advancement of Investor Rights urges regulators across the country to develop detailed standards for risk-tolerance assessment swiftly and to make compliance with those standards mandatory for all advisors and their dealers as part of the KYC process.

From all the studies performed and articles written on the topic around the world, it is very clear that risk profiling has caught the attention of regulators internationally.

4. Risk profiling: An industry dilemma

Historically the financial services industry in South Africa has followed the lead of other regulators, like the UK and Australia for example. The introduction of the Financial Advisory and Intermediary Services Act and Treating Customers Fairly (TCF) are prime examples of this fact. Judging by this trend, it is simply a matter of time for the Financial Services Board of South Africa to intervene when it comes to the disclosure of risk and the application of risk profiling. All the signs are there, e.g.:

4.1 The 2011 FSA Report
4.2 The 2012 FAIS Ombud Report
4.3 International Studies
4.4 Treating Customers Fairly

One of the objectives of this paper is to identify the problems, recognise the signs and urge all stakeholders in the financial services industry to be proactive in addressing the problem, rather than to wait for the regulator to intervene. Although this may appear to be a financial services provider problem, all the industry stakeholders have one mutual client, namely the customer. All industry stakeholders are therefore interdependent of each other in serving the customer and as a result, product suppliers have a major contribution to make in coming up with sound and practical solutions. The following stakeholders will each have a unique role to play in the search of the correct approach:

[17] FSA Report March 2011, page 16
[18] FSA Report March 2011, page 16

The customer

The common objective of FAIS and TCF is consumer protection and placing the customer's interest at the center of everything providers and product suppliers do. Consumer education is a vital building block in the process of providing appropriate investment advice. The customer will have to be receptive to being educated during the advice process. This is going to require participation and patience in the process.

The advisor / intermediary

The FAIS Ombud's determinations have clearly demonstrated that ignorance is no excuse. If financial services providers do not understand the fundamentals of suitability of advice, they will be held accountable, and so they have been. Providers will have to educate themselves with regard to investment risk and the appropriate application of risk profiling questionnaires. Providers will also have to learn how to determine an investor's risk profile in a fundamentally sound manner. Understanding the risk profile of an investor is of fundamental importance because it lays the foundation of suitable advice. Of further importance is for providers to communicate this concept to investors in a way that they understand it.

In view of the fact that the responsibility of recommending financial products in accordance with an investor's risk profile and needs is placed on financial services providers and the fact that they are being held accountable for it, the arguments contained in this paper is formulated from a provider's perspective. Traditionally financial services providers allowed product suppliers to define risk and to design risk profile questionnaires without questioning the fundamentals of the design or designing alternative questionnaires. Unfortunately financial services providers are being held accountable for the outcomes of these risk profile questionnaires designed by external parties that are not subject to the FAIS Act. The lesson that financial services providers should learn from this is that one should never outsource a vital function to a party that cannot be held accountable for that function. The mere fact that financial services providers are being held accountable for the outcomes and application of risk profile questionnaires calls for providers to take full ownership and responsibility for the future design of risk profile questionnaires.

The product supplier

Finding appropriate solutions for the risk profiling problem will require collective effort. Product suppliers will continue to play a very important role in the process and the timing for proper collaboration between financial services providers and product suppliers in South Africa is excellent. Treating Customers Fairly (TCF) has been instrumental in bringing industry stakeholders closer together and it has paved the way for providers and product suppliers to combine resources and enter into a constructive debate to resolve the problems to serve customers better – together.

Providers and product suppliers are interdependent and all the industry stakeholders will benefit from their collective efforts in designing better solutions.

National Treasury / FSB

National Treasury and the Financial Services Board could play a pivotal role in the process of finding solutions if the representative bodies of financial services providers and product suppliers cannot come to a sensible agreement. However, it is proposed that the Advisor's Risk Profiling Workgroup, with the support of the Financial Intermediaries Association and Financial Planning Institute of Southern Africa, make submissions to ASISA and some of its leading members and be offered an opportunity to resolve the issues before involving the regulator. At the same time all parties should acknowledge that the subject of risk profiling forms part of the requirement of providing suitable advice, which is part of outcome 3 of Treating Customers Fairly. There is nothing to prevent National Treasury or the FSB from including the concept of risk and/or risk profiling into the TCF framework.

5. Common flaws

From the international studies as referred to in this paper - the 2011 FSA Report in particular - as well as the 2012 FAIS Ombud Report it appears that a number of flaws have been identified which apply internationally. The following flaws have already been identified:

5.1 Risk is not disclosed in clear unambiguous language.[19]

5.2 Risk profile questionnaires are not always relevant to the investment at hand.[20]

5.3 Risk profile questionnaires can be interpreted in several ways.[21]

5.4 Many risk profile questionnaires are flawed because they do not determine investors' risk tolerance accurately.[22]

5.5 Questionnaires use poor questions and answer options and have over-sensitive scoring or attribute inappropriate weighting to answers.[23]

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[19] FAIS Ombud Report 2012
[20] FAIS Ombud Report 2012
[21] FAIS Ombud Report 2012
[22] FAIS Ombud Report 2012
[23] FSA Report March 2011, page 3

5.6 Flaws in questionnaires can lead to inappropriate conflation or interpretation of customer responses.[24]

5.7 Many examples of descriptions have been found to be vague and do not effectively explain or differentiate levels of risk.[25]

5.8 Even where the risk profile has been correctly assessed, the product or portfolio does not always match this profile.[26]

5.9 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.[27]

5.10 Customer risk category descriptions are unclear or misleading.[28]

5.11 Descriptions or illustrations do not clearly quantify the level of risk.[29]

5.12 Description of the investment strategy is inconsistent with most customers' understanding of the risk posed by the category description, i.e. cautious.[30]

The workgroup unanimously agreed, as per the previous meeting, that risk profile questionnaires using terminology such as conservative, moderate and aggressive, which are vague and not quantified objectively are fundamentally flawed and should be abolished;

It should be absolutely clear from the reports and all the FAIS Ombud determinations that have been published over the past few years that solving the challenges as highlighted above are long overdue. The time has come for all the industry stakeholders to work together in solving this challenge for the ultimate benefit of customers.

6. The fundamentals

Every good argument has to be built on a sound foundation. It is for this reason that any attempt to formulate a meaningful solution, should be based on sound principles. The first aspect that all stakeholders must acknowledge is that proper disclosure of

[24] FSA Report March 2011, page 3
[25] FSA Report March 2011, page 4
[26] FSA Report March 2011, page 4
[27] FSA Report March 2011, page 4
[28] FSA Report March 2011, page 16
[29] FSA Report March 2011, page 16
[30] FSA Report March 2011, page 16

risk and the correct application of risk profiling are statutory duties of financial services in terms of the FAIS Act and its subordinate measures, which states that[31]:

A provider other than a direct marketer, 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;

In view of the aforementioned obligations our proposals are based on the following principles:

6.1 Risk should be clearly defined

One of the main causes for the problems that exist with regards to risk profiling is the fact that risk is not properly defined. Historically industry stakeholders defined risk from their own perspectives. For example:

6.1.1 *Fund managers* referred to investment risk as "standard deviation", which can be defined as a measure of the spread of a sample of numbers around their arithmetic mean. It is equal to the square root of the variance, which is the mean of the squares of the deviations of ach number from the mean of the sample.[32] During a fund due diligence exercise in June 2014 it appears that the leading fund managers in South Africa have recently changed their definition of risk to "permanent loss of capital".[33]

6.1.2 *Financial advisors* referred to risk as "loss of capital" but also as "an investment return that does not match or outperform inflation over the investment term".

[31] See section 8 of the FAIS General Code of Conduct
[32] See the Unit Trust Handbook of March 2014 published by Profile Media on page 102
[33] Answers provided by Coronation Fund Managers, Foord, Investec and RE:CM

6.1.3 *Customers* refer to risk as "loss of capital" or "loss of investment value", which is consistent with the normal meaning of the word[34] and how the FAIS Ombud interprets risk.[35]

6.2 Risk should be defined from the customer's perspective

It is proposed that all stakeholders adopt a common definition of risk, which places the customer at the center for the following reasons:

6.2.1 It is consistent with the normal meaning of the word "risk" according to the dictionary, namely the possibility that an asset may fall in value.[36]

6.2.2 It is aligned with the objective of the FAIS Act, namely consumer protection.

6.2.3 It is consistent with the outcomes of TCF, namely treating customers fairly.

6.2.4 All the stakeholders have one common client, namely the end consumer. As a result, it is proposed that all industry stakeholders should align their terminology and services with the customer in mind. Defining risk from the customer's perspective will lay a sound foundation for sound and consistent use of terminology and disclosures to customers.

6.3 Risk defined

In view of the aforementioned, it is proposed that *risk* is defined as ***"the temporary or permanent loss or decrease of a client's investment value"***.

This definition should cover most of the circumstances customers would want to avoid, such as:

6.3.1 A temporary loss of capital and/or investment value

Over the last few years thousands of investors who have been invested in unlisted property investment schemes have been exposed to this type of risk. Investment capital got caught up in property investments of which the management of these companies have changed as a result of a Court order and investors cannot get access to their capital. It is argued that investors have not lost their capital, they simply do not have access to their capital as new management promises to pay back capital over an extended period.

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[34] The Pocket Oxford Dictionary, 5th Edition1977, p 716 refer to risk as "expose to chance of …loss"

[35] See Chistoffel Andries Schutte v R&S Walsh Investment Consultants CC and others FAIS 03984/09-10/EC1

[36] See Oxford Business English Dictionary, Oxford University Press 2008, p 476

6.3.2 *Permanent loss of capital and/or investment value*

This risk speaks for itself and there is plenty of evidence of investors who have lost all their invested capital.

6.3.3 *A decrease of a client's investment value*

In the matter between Christoffel Andries Schutte and R&S Walsh Investment Consultants CC the FAIS Ombud clearly highlights this as a risk.[37]

6.4 Risk profile should be clearly defined

From the FAIS Ombud's determinations it appears that a client's *risk tolerance* has been the primary consideration. According to international studies however, it is clear that there are other considerations that should also be taken into account, such as the client's *required risk* and *risk capacity*.

6.5 Risk profile defined

According to the FSA Report,[38] even where the risk profile (of the customer)[39] has been correctly assessed, the product or portfolio does not always match this profile. This means that there is often a disconnect between the customer's (client) risk profile and the risk profile of the investment portfolio or fund. In view of the aforementioned it is proposed that the following definitions be considered by the stakeholders:

6.5.1 *Risk profile of the customer (client)*

A lot of work has been done internationally[40] with regard to this particular definition and it is proposed that, in order to be consistent with terminology used internationally, we adopt the following definitions pertaining to risk profile as referred to in the General Code of Conduct[41]:

6.5.1.1 *Risk profile*

Risk profile is the appropriate level of investment risk having regard to (the investor's)[42] risk required, risk capacity and risk tolerance.

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[37] See FAIS 03984/09-10/EC1
[38] See FSA Report March 2011, page 4
[39] My insert
[40] FinaMetrica, curtesy of Geoff Davey, cofounder and director
[41] See section 8(1)(c) of the FAIS General Code of Conduct
[42] My insert

6.5.1.2 *Risk required*

Risk required is the risk associated with the (investment)[43] return that is required to achieve the individual's goals from the resources available.

6.5.1.3 *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.

6.5.1.4 *Risk tolerance*

Risk tolerance is the individual's general willingness to take financial risk. It is a psychological trait.

6.5.2 Risk profile of the investment

The Oxford Dictionary defines *risk profile* as "an analysis of a possible investment that considers how likely it is to result in a loss".[44]

In view of the fact that financial services providers are ultimately responsible to identify investment product(s) that is/are appropriate to the client's risk profile and financial needs, it is important that investment managers align the risk profiles of their funds with the definition of risk as understood by investors. If investment managers are willing to adopt this approach, it would go a long way in assisting the industry in solving some of the problems as recorded in this paper.

7. A proposed framework

The workgroup agreed that it would be pointless to simply highlight the problems and flaws of current practices without making any meaningful recommendations. As highlighted above, one of the objectives of this paper is to provide the industry with a well-researched document for consideration and to stimulate constructive debate between all the stakeholders.

The Workgroup agreed that risk profiling should be done much **SMARTER** in future and propose that the following fundamentals should form the basis when establishing an investor's risk profile:

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[43] My insert

[44] See the Oxford Business English Dictionary, Oxford University Press, 2008, page 477

7.1 <u>S</u>pecific and Simple

The concepts of "risk" and "risk profile" must be properly defined in <u>clear and simple language</u> so that clients can understand it, advisors can apply it and that it leaves less room for interpretation by any of the other stakeholders. It is proposed that defining risk as "standard deviation" as referred to in the Unit Trust Handbook of 2014 is not the answer, but that consideration is given to the proposals contained in 6 above.

7.2 <u>M</u>easurable

One of the main problems regarding the disclosure of risk to customers is that it is not quantified and vague. In the words of the Ombud: "Risk is not disclosed in clear unambiguous language". We would argue that one of the main reasons why risk profile questionnaires can be interpreted in several ways is the fact that risk is not quantified properly. If risk cannot be quantified, 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 measured and better managed.

It is proposed that risk be expressed in a way that investors can understand it and in a way that advisors can explain it in clear and unambiguous language. Simply put, it must be made clear by how much an investment can depreciate in value over a specific investment period. Product suppliers have already suggested a change in this direction by reporting maximum drawdown statistics. It is proposed that risk is disclosed as the possibility of losing X% over a 12 month rolling period. Apart from defining risk properly from a customer's perspective, quantifying risk properly is arguably the single most important thing that industry stakeholders should agree on in our attempts to solve the problems highlighted by the FAIS Ombud in their report.

7.3 <u>A</u>ttainable

We know that risk and return go hand in hand. The risk/return trade-off must realistic and attainable. Sometimes even fund managers are instrumental in creating unrealistic expectations in the minds of advisors and their clients. For example: One has to ask whether a targeted return of inflation plus 6% net of cost over a rolling 5 year period with no chance of loss over any 12 month rolling period is attainable? If risk and return are quantified all industry stakeholders will be able to establish whether it is realistic and attainable.

7.4 Risk and risk profile should be properly defined

Solving the problems as highlighted in this paper starts with a proper definition of risk from a customer's perspective and a proper definition of risk profile. It is proposed that the recommendations made in this regard as contained in this paper be used as the basis of the discussions between the stakeholders. The workgroup has agreed on three elements, as highlighted above, which should make up the risk profile of a client.

Risk tolerance should not be the main consideration in determining whether suitable advice was given or not. As proposed above, there must be a balance between the components that make up the risk profile of a client. This is very clear from the following provisions in the General Code of Conduct:[45]

(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;

7.5 Term plays a vital role

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. The Advisor's Risk Profiling Workgroup has agreed that the investment term, not the customer's age, should be the primary consideration in determining the customer's needs and risk profile.

7.6 Education is key

Consumer education plays a critical role in the advice process and in the process of leading an investor to make an informed decision. This obligation is particularly challenging for providers in an onerous regulatory environment. The Workgroup agreed that, without investor education investors will in all probability not understand their financial needs and objectives properly, nor will they understand the risk required to achieve those investment objectives, whether they can afford those risks or whether they will be able to tolerate those risks.

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[45] See section 8(1) of the General Code of Conduct

7.7 Risk / Return expectation of the client must be agreed and recorded

From an investor's point of view one of the most important aspects that should be agreed on is his/her risk/return expectation. One of the main contributors to provider liability over the years has been poor record-keeping on the part of financial services providers, with particular reference to the client's risk/return expectation. At the 2014 Insurance Conference held at Sun City the Assistant Ombud, Mr David Davidson was asked to rate the quality of record-keeping by financial advisors and he rated it 3/10.

If the client's needs, objectives and risk profile (as defined above) have been highlighted, explained and discussed and there is a mismatch between the client's required risk and risk tolerance, the workgroup agreed with international commentators that it is not the advisor's problem. At the end, if all the components were explained properly, the ultimate components that have to be agreed to between the parties are the risk and return expectations. If neither of these components can be quantified, both advisor and investor are at risk in the process. The outcomes of both scenarios should be explained and the client will have to choose which option he/she can live with. This choice should then be clearly recorded.

An example of such an agreement would be where a client expects a return of inflation plus 5% per annum over a five year rolling period and is willing to accept a 15% decrease in value of his/her investment over any 12 month rolling period. If the client is not willing to accept a 15% "loss" or "decrease in value" of his/her investment in any given 12 month period, then he/she has to lower his/her expectations. The most important part of risk profiling is to agree and record the client's risk / reward expectation in writing to prevent selective memories to dictate the outcome of a complaint.

8. The role of product suppliers

As highlighted above, product suppliers, investment management companies in particular, can play a significant role in solving the challenges as described in this paper. A number of leading fund managers have already started a process of change in their risk disclosures on their fund fact sheets, which is extremely encouraging.

The mere fact that a number of the leading fund managers in South Africa no longer define risk by referring to standard deviation, but refer to risk as the "permanent loss of capital" is already a step in the direction of alignment between the key stakeholders. Another source of encouragement is the fact that many of the fund managers have also included maximum drawdown figures on their fund fact sheets, which indicates that there is a mutual desire to be transparent, specifically when it comes to the disclosure of risk. These developments are further proof that TCF is pulling industry stakeholders closer together and perhaps there has never been a better time for us as an industry to resolve these issues together.

During a number of informal discussions with leading fund managers it appears that they are more than willing to participate in discussions with financial services providers with the aim to resolve the problems.

9. A proposed plan of action by all the stakeholders

It should be clear from the FSA Report, various articles by leading financial planning firms, financial planning services providers like FinaMetrica, The Institute for Behavioural Finance and the concerns expressed by the FAIS Ombud that it has been long overdue for the financial services industry in South Africa to establish a sound framework for the proper risk profiling of customers. The Workgroup proposes that:

9.1 This paper be circulated to all the representative bodies of the various stakeholders for comment;

9.2 This paper be circulated to National Treasury and the Financial Services Board as a courtesy;

9.3 Industry stakeholders are invited to submit comments and recommendations for further discussion.

Submissions must please be sent to Anton Swanepoel in his capacity as facilitator of the Advisor's Risk Profiling Workgroup at anton@amitywealth.co.za by no later than **15 November 2014**. He can also be reached on 082 453 4184.