

# Investment Suitability

Investment advice facing  
new challenges





# Editorial

Dear Readers

2008 was a year marked by periods of turbulence on the financial markets. Institutional and private investors alike saw themselves confronted with diminished portfolios, which has led many of them to question whether they were sufficiently informed by their investment adviser about the risks of the recommended financial instruments and whether these instruments even meet their investment needs, i.e. the recommendation of suitable financial instruments (Investment Suitability) when providing investment advice.

## What is Investment Suitability?

Until recently, there was no uniform regulatory framework with defined guidelines in place, not even at a European level. However, this changed in 2007 with the implementation of the EU Markets in Financial Instruments Directive (MiFID). Also the Swiss supervisory authority FINMA now recognizes a possible need for adjustment in the regulation of the sales process for financial instruments, stating: "We are pursuing a form of regulation that will achieve an effect similar to parts of MiFID, but on a smaller scale."<sup>1</sup>

## What information does this brochure contain?

This publication provides Swiss financial services institutions with an introduction to Investment Suitability. We have selected five specific areas and provided you with some 'food for thought' on reducing legal and reputational risks, as well as risks of sanctions. Dealing with these risks in the right way will also enhance the quality of your investment advice.

Investment Suitability is presenting investment advisers with new challenges. This brochure is part of the Investment Suitability initiative for our Swiss clients.

We hope you find this an interesting and informative read. If you would like to arrange an informal meeting to discuss the Investment Suitability challenges facing your company, please do not hesitate to contact us.



A stylized, handwritten signature in black ink.

Iqbal Khan  
Partner



A stylized, handwritten signature in black ink.

Stéphane Muller  
Partner

<sup>1</sup> Interview with Eugen Haltiner, Chairman of the FINMA Board of Directors, in "Schweizer Bank" magazine (January 2009)

# Introduction

## What exactly does Investment Suitability mean?

For various reasons, the main concern of financial services institutions today is whether the services and financial instruments they recommend are, in fact, suitable for each individual client.

In April 2008, the Joint Forum<sup>2</sup> published a study on this subject, identifying an upward trend in the importance attached to Investment Suitability, as well as the tendency of supervisory regulations in this area to converge globally. Furthermore, the study highlighted the international relevance of the European Market in Financial Instruments Directive (MiFID).

“Assuring suitability is a core element of today’s advice and investment process.”

MiFID imposes various obligations on financial services institutions who offer investment advice or asset management services to inexperienced clients. This applies, in particular, to gathering information on (1) clients’ financial situation, (2) their knowledge of and experiences in particular types of investment products and the particular type of service being provided, and (3) their investment objectives. For experienced clients (i.e. professional clients), requirements are limited to verifying whether an intended transaction satisfies the client’s investment objectives.

If the financial services provider fails to receive the required information, or a service or financial instrument appear to be unsuitable for the client based on the information collected, then these must not be recommended to the client.

The legal framework, at least within the European Economic Area (the geographical scope of MiFID), thus defines assuring the suitability of services and/or financial instruments as a core element of today’s advisory and investment process.

## What is the current situation in Switzerland?

Regulations equivalent to those in MiFID do not exist in Switzerland. Rather, rulings by the Federal Supreme Court on this subject are consistent with the prevailing model in that neither investigating clients’ financial circumstances nor assessing the suitability of a transaction for a particular client falls under the market’s statutory duty to inform (BGE 133 III 97, E.5.4).

However, in its decision of June 13, 2008, the Federal Supreme Court once again stated that, pursuant to mandate law, an investment adviser or broker working in the field of asset management has the duty to (1) disclose to the client the risks of the intended transaction, (2) provide tailored and appropriate advice, when asked, on the individual investment opportunities, and (3) warn against any rash decisions (BGE 4C.68/2007, E.7.1).

“Investment advisers must understand and take into account the client’s degree of knowledge and risk tolerance.”

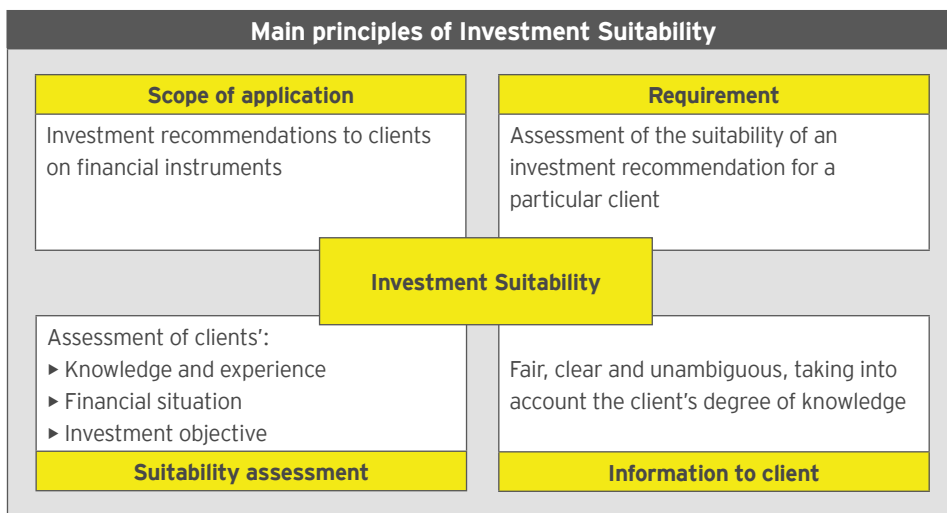
In terms of content, this duty is determined by both clients’ degree of knowledge and the nature of the investment in question. Of particular interest is the Federal Supreme Court’s conclusion that advisers bear a special duty to interview clients for a close understanding of their (1) degree of knowledge and (2) risk tolerance.

### Requirements in Switzerland

- ▶ Disclose risks
- ▶ Interview clients to understand their degree of knowledge and risk tolerance
- ▶ Provide tailored advice
- ▶ Warn clients where appropriate

Source: Federal Supreme Court decisions

<sup>2</sup> Basel Committee on Banking Supervision - The Joint Forum: “Customer suitability in the retail sale of financial products and services” (the authors of this study define ‘retail sale’ to be sales to private investors).



Risk disclosure, questions regarding the degree of knowledge and risk tolerance, tailored advice and any warnings: these requirements typically apply to classic investment advice and equally apply to asset management within the framework of a management mandate, when the contract is concluded.

Investment advice: categorization	
<b>Wealth Management</b> <ul style="list-style-type: none"> <li>▶ Mandate for managing client portfolio</li> <li>▶ Financial services provider makes investment decisions</li> </ul>	Investment decision made by... ↑ ...financial services provider ↓ ...client
<b>Private Banking</b> <b>(focal point of this brochure):</b> <ul style="list-style-type: none"> <li>▶ Wealth Management without a mandate</li> <li>▶ Advice and recommendations for the client</li> <li>▶ No independent investment decisions made by financial services provider</li> </ul>	
<b>Execution only:</b> <ul style="list-style-type: none"> <li>▶ Strictly an account/portfolio relationship</li> <li>▶ No Wealth Management</li> </ul>	

A detailed discussion of the extent to which, in content, the rulings by the Federal Supreme Court converge with European “suitability rules” is beyond the scope of this brochure. The fact remains that major financial services institutions operating in Switzerland have begun to adapt their own advisory and investment processes accordingly.

“The financial crisis has increased the importance of Investment Suitability.”

**What makes suitability such a hot topic?**

If they address the suitability criterion only partially or not at all, financial services institutions automatically expose themselves to both legal and reputational risks as well as the risk of sanctions, all of which are difficult to calculate.

There is no doubt that the financial crisis has contributed significantly to raising awareness of this problem both in the public arena and among supervisory authorities.

Financial services institutions are under markedly more pressure to begin providing appropriate solutions. The following pages briefly present Ernst & Young’s own experiences and solutions which demonstrate that incorporating seemingly simple requirements into the advisory and investment process is in fact a complex and demanding task.

The information we provide here centers on the following issues:

Relevant questions	
How are the principles of Investment Suitability applied in the contexts of client, portfolio and product?	Page 6
Which factors determine customized risk disclosure and its verifiability?	Page 9
What does portfolio diversification mean in accordance with Federal Supreme Court practice?	Page 11
Why should concentration risks (e.g. issuer, investment manager) be monitored across all client portfolios?	Page 13
Why is investment advisers’ product-specific training important?	Page 15

# 1. Client investment profile and product classification

## Relevant question

How are the principles of Investment Suitability applied in the contexts of client, portfolio and product?

To meet Investment Suitability requirements, investment advisers must take a large amount of information into account before recommending a financial instrument. Deciding how best to gather this information directly from the client already presents a challenge, not to mention the client's own expectations regarding the quality of the advice (*product demand side*).

Today, open architecture products offerings are a common sight on the product supply side, which means investment advisers must choose from a wide variety of financial products when providing clients with a recommendation. Furthermore, financial services institutions must stay abreast of new product innovations, taking these too into account when making an investment recommendation.

Ultimately, investment advisers should seek to match up *product supply* and *product demand* to provide the client with a tailored investment recommendation. This raises various questions:

- ▶ How can investment advisers determine which loss risks a client is able to bear?
- ▶ How can they tell which financial instruments are understood by a given client and which are not?
- ▶ What is the best way to rate the complexity of a financial product?
- ▶ Depending on the complexity of a particular financial product, how can advisers judge whether clients are out of their depth or not?
- ▶ Should advisers consider loss risks at product or at portfolio level?

### Client investment profile

Most financial services institutions already use standardized methods in processing client information when a business relationship begins. These are often limited, however, to determining clients' financial situation and investment objectives.



Clients' knowledge and experience in dealing with financial products is largely ignored, despite the fact that such information is essential in developing tailored investment recommendations. Recommending a complex financial instrument to someone with little to no financial knowledge, then, will be hard to justify in terms of the principles of Investment Suitability. So what is the best way to collect the required information?

In our experience, the use of standardized questionnaires is particularly well-suited to achieving the right degree of objectivity. Clients may complete the questionnaire on their own or with guidance from their investment adviser. Information relating to clients' financial situation and investment objectives can be gathered either using the questionnaire or by other means. Updating this information regularly is recommended as clients' needs may change over time.

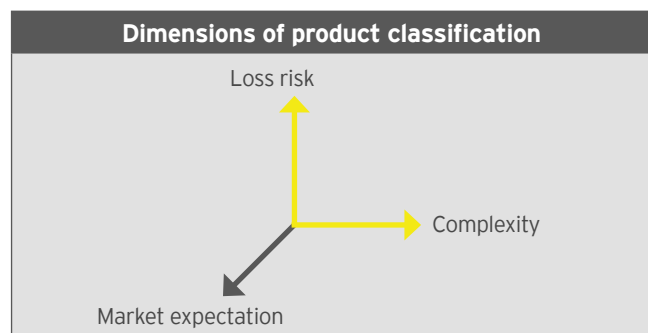
"Assessing the client's risk tolerance and degree of knowledge using questionnaires and the scoring model."

Various methods are available to calculate a score for the client based on this information, providing investment advisers with a clear point of reference within the three-dimensional investment profile of a given client. Product classification is needed to match the client's score with the financial instruments on offer. This classification uses dimensions similar to those in the client investment profile to help navigate the product universe.

"Product classification provides a sense of direction within the product universe."

### Product classification

The loss risk (e.g. Value at Risk) and product complexity (e.g. the payoff structure, number of underlyings etc.) have proven themselves to be principal dimensions of product classification. The market expectation, i.e. the investment idea underlying the financial instrument (e.g. the falling price of the underlying), is generally not taken into account during classification.



How can an investment recommendation be made based on the client's investment profile and the product classification?  
 Is it necessary to contrast each dimension relating to client and product individually as a means of assessing suitability?

In Europe, a suitability declaration is generally required for each transaction and product. A dynamic product classification will meet this requirement. As its name suggests, this classification must be repeated regularly as it can be influenced by dynamic factors, such as changes in the issuer rating. Dynamic product classification is used in Germany, for example.

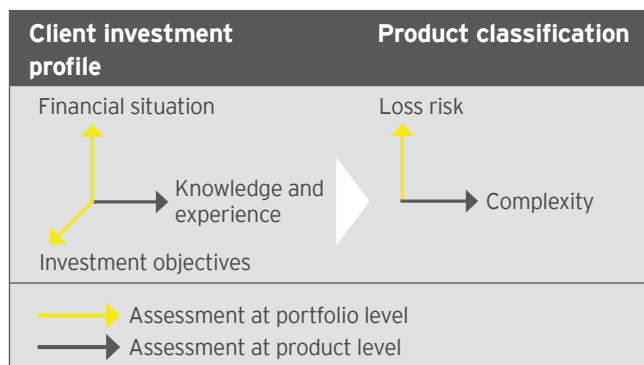
There is (as yet) no comparable requirement in Switzerland, although dynamic product classification is particularly helpful to retail clients. The additional transparency helps investors who tend to be unfamiliar with this sector. The portfolios of these clients also tend to be insufficiently diversified, which justifies loss risks assessment at product level.

That said, we see no benefits in dynamic product classification in cases of diversified portfolios with long-term investment horizons. Not only is it an intricate process, it may also contradict basic tenets of modern portfolio theory, resulting, for example, in unwanted correlations among financial products at portfolio level. In such cases, we recommend assessing the dimensions of *financial situation and loss risk* for each portfolio separately.

### Advantages

The compilation of client investment profiles and product classifications meets international regulatory requirements (depending on the actual form these take). Directly linking the client's investment profile and the product classification with the customized risk disclosure significantly reduces any legal risks.

Overview of advantages		
Risk mitigation	Quality improvement	
+++	++	
+++ significant	++ average	+ low



However, clients' knowledge and experience of the product or product category should match the financial instrument's degree of complexity. In other words, a financial instrument should only be recommended to a client if the client understands both the product itself and, crucially, its opportunities and risks. A one-off, static product classification will take care of this, however, and even links up easily with customized risk disclosure (see section 2 on page 9).



“Investment advisers  
are facing more pressure  
than ever before.”

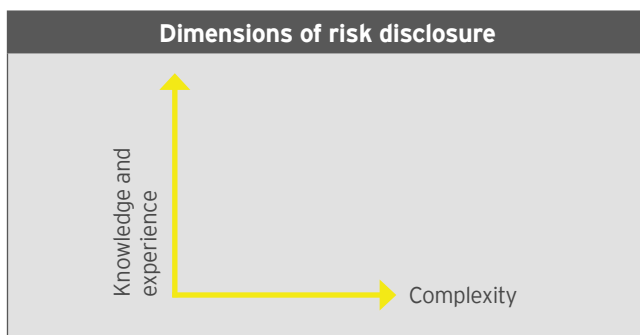
## 2. Risk disclosure and verifiability

**Relevant question**

Which factors determine customized risk disclosure and its verifiability?

The challenge of risk disclosure lies in ensuring its suitability and verifiability.

By and large, standardized risk disclosure today amounts to mailings of the brochure “Special Risks in Securities Trading” issued by the Swiss Bankers Association, whereas customized risk disclosure is provided in the form of product-specific information given out during personal consultations.



In many cases, risk disclosure as it is offered today falls short of fully or even remotely addressing either the client's degree of knowledge and experience or the complexity of the product. The level of risk disclosure should generally be inversely related to the client's degree of knowledge, in terms of both length and style.

“There is a lack of standardized tools for customized risk disclosure.”

Whereas general risk disclosure can follow a standardized format, customized risk disclosure is largely influenced by the client's degree of knowledge. Experience shows that investment advisers often lack the standardized tools necessary to provide customized risk disclosure. Linking the degree of knowledge with product complexity proves especially difficult.

Risk disclosure as currently practiced may provide sufficient (legal) security for part of the transaction, but there is still room for improvement, particularly with regard to the Federal Supreme Court ruling on contract law described in the introduction. If carefully put together at the outset of the business relationship, a client investment profile that adequately takes the client's own degree of knowledge into account will allow for better streamlining of customized risk disclosure. This contributes to greater efficiency by reducing the need for risk disclosure over the course of the business relationship, in contrast to a scenario where client investment profiles are inadequate or inexistent. Requiring clients to sign their client profile further reduces potential exposure to legal actions.

“Product-specific statements signed by the client significantly reduce legal risks.”

It is also advisable to present product-specific statements for signature as evidence that customized risk disclosure has been carried out, particularly in the case of clients with a low degree of knowledge. In these statements, the client confirms that the investment adviser has explained any product-specific risks and that this information has been understood.

If however specific circumstances suggest that even after customized risk disclosure, a client still does not understand the risks involved with the product, then the product is not suitable for this client.

### Advantages

For well-informed clients, a carefully put-together client investment profile makes for more efficient customized risk disclosure. Signed, product-specific statements meanwhile are recommended for clients with a lower degree of knowledge, as long as the financial product is not deemed to be unsuitable for the client. Such measures can significantly reduce exposure to both legal and reputational risks.

Overview of advantages	
Risk mitigation	Quality improvement
+++	+
+++ significant	++ average      + low

“It’s not just experts who should be able to understand diversification standards.”



### 3. Portfolio diversification standards

**Relevant question**

What is the meaning of portfolio diversification in accordance with Federal Supreme Court practice?

In its 2007 decision, the Federal Supreme Court stated that a duty to inform arises if a portfolio is concentrated on only one security (or only a few securities), provided that a qualified fiduciary relationship exists between the bank and the client, as is typical of investment advice. The Federal Supreme Court quantified the concentration within specific components of a portfolio (“shares and share funds”) and across the portfolio at the time the securities in question were purchased. It concluded that a concentration risk existed and that the bank should have informed the customer of it, despite the fact that this position accounted for no more than a low double-digit percentage of the portfolio’s overall value.

Financial services institutions now faced the challenge of defining diversification standards that meet the requirements of modern portfolio theory and legal practice all at once. The standards must be drafted in such a way that users need not be experts to be able to interpret and comply with them.

It is therefore recommended that financial services institutions set portfolio diversification standards for the following three elements:

- ▶ Financial instruments: maximum percentage share of portfolio value per financial instrument
- ▶ Issuers: maximum percentage share of portfolio value per issuer
- ▶ Correlation between branches, countries and foreign currencies: maximum percentage share of the portfolio value per dimension

Advisers should take existing client segments and the advisory process into account when defining the standards, to support the effectiveness of these requirements.

Once the standards are defined, they can provide investment advisers with a useful tool that is easy to apply and is indispensable as a basis for monitoring portfolio diversification. How the monitoring is carried out depends largely on the size of the institution. Manual monitoring should be appropriate only for smaller financial services institutions as, in other cases, suitable support tools are needed to ensure effective monitoring.

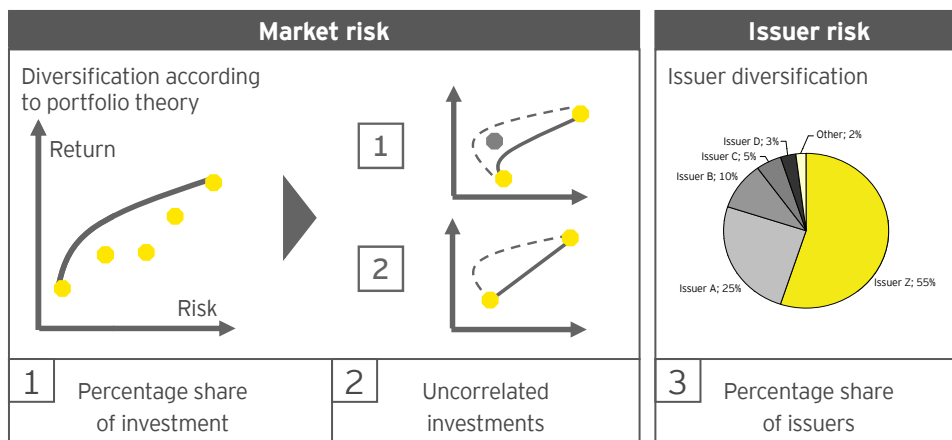
**Advantages**

It is in both the management’s and investment advisers’ fundamental interest to define and monitor (quality) standards for portfolio diversification.

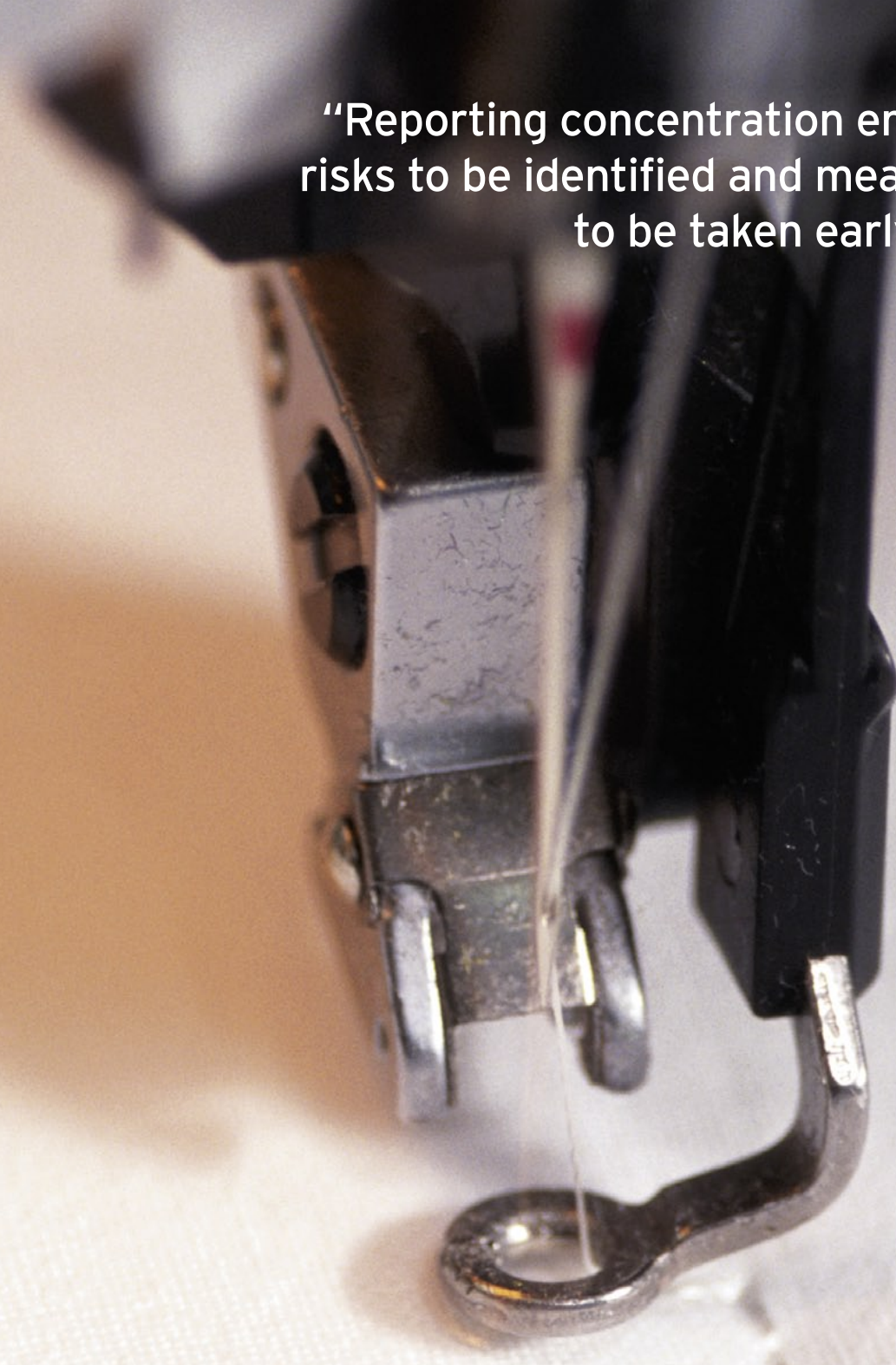
The transparency achieved by doing so underpins compliance with the legal and regulatory framework.

Appropriate diversification is the requirement for the solution for the product classification described in section 1 on pp. 6-7.

Overview of advantages		
Risk mitigation	Quality improvement	
+++	++	
+++ significant	++ average	+ low



“Reporting concentration enables risks to be identified and measures to be taken early on.”



# 4. Concentration risks at bank level

**Relevant question**

Why should concentration risks (e.g. issuer, investment manager) be monitored across all client portfolios?

Diversification standards are an important factor both for the individual client portfolios and at institute level.

Heavily concentrating on financial products from just one issuer or investment manager can lead to both legal and reputational risks in the event of issuer default or a poor investment performance. This can, in turn, give rise to major client protests and class actions, as recently witnessed in various countries.

### Using concentration reporting as a basis for decision-making

Against this background, appropriate reporting of concentration risks provides a suitable basis for decision-making and enables institutions to react early on to any problem appearing on the horizon.

"Aggregated concentrations across all client portfolios are too often ignored."

Yet in practice, the challenge often lies in creating a workable structure and database to generate such reporting.

### Measures

A strategy for concentration reporting can be put together for management based on the following measures:

- ▶ Centralizing various data sources (keyword: business intelligence)
- ▶ Defining aggregation criteria that are relevant to the financial intermediary. Examples of suitable criteria include issuers, individual product types, and risk-exposed products
- ▶ Defining concentration limits and binding escalation processes

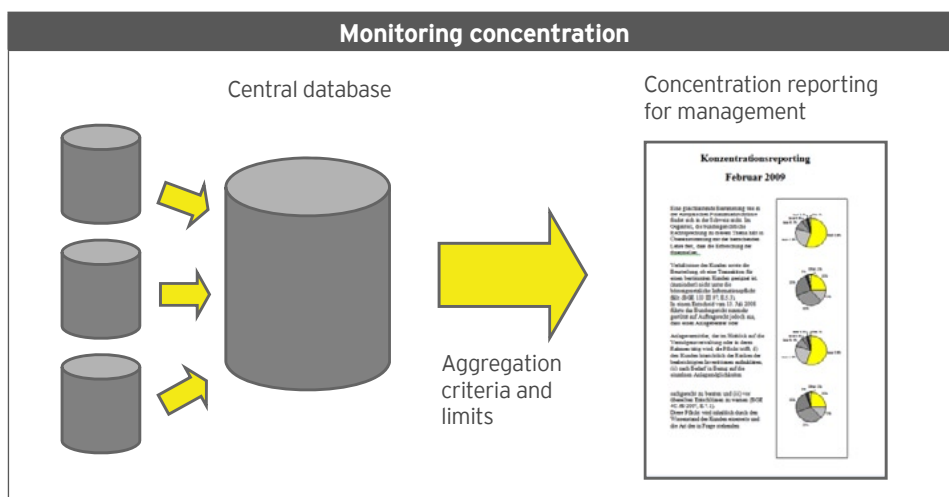
### Advantages

This very topic - "issuer risk" - should be of significance in the future. Clients do not just expect appropriate risk disclosure on issuer risk; they also expect proactive information at the earliest sign of a problem with the issuer. Despite the fact that there are currently no legal provisions for this type of "ex post" transaction warning, things look set to develop in this direction.

Concentration reporting enables financial services institutions to identify latent risks and initiate appropriate action early on.

**Overview of advantages**

Risk mitigation	Quality improvement
+++	+
+++ significant	++ average + low



“Even basic financial products require expert knowledge.”



# 5. Training for investment advisers

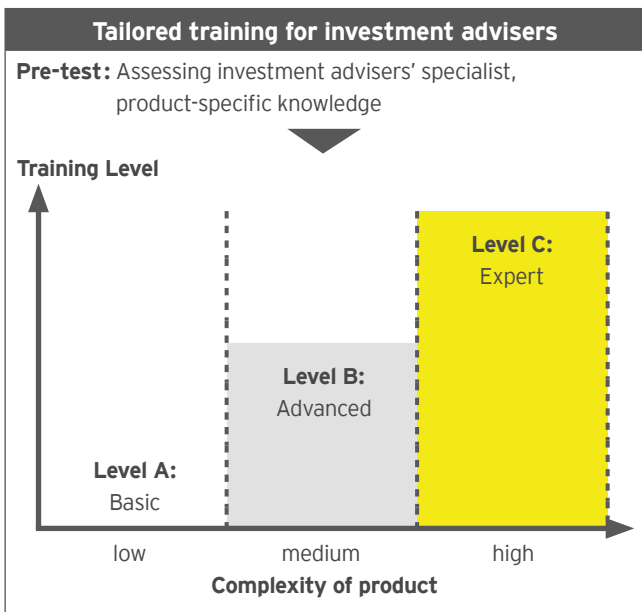
**Relevant question**

Why is the investment adviser's product-specific training important?

The increasing complexity of financial products confronts investment advisers with major challenges. The general consensus is that the current trend towards simpler and more transparent financial products looks set to continue. Even so, expert knowledge is still required for a sound understanding of how even seemingly basic products work - particularly in exceptional situations on the financial markets. Furthermore, it is fundamental to the ability to provide appropriate risk disclosure to clients (see section 2 on page 9).

This explains why education and training on product knowledge is seen as so important among financial services institutions.

Tailored solutions that take their existing specialist knowledge into account are what investment advisers look for in this regard to avoid redundancies.



In view of this, it is advisable to offer investment advisers a status review by way of a pre-test. The pre-test results are then used to suggest a suitable training level (basic, advanced or expert) for a given training course.

Where a program actively managing the legal and reputational risks is in place, an additional option lies in authorizing recommendations of especially complex or risk-intensive products only by those advisers who command the level of specialized knowledge such products require.

“Investment advisers need to possess the knowledge relevant to their client segment.”

### Advantages

In today's world, high-quality investment advice calls for extensive, product-specific knowledge. Combining the pre-test with individual training levels responds to this need by providing investment advisers with the customized knowledge needed to serve their particular client segment.

This significantly reduces risks that may arise when clients are given false or insufficient information.

**Overview of advantages**

Risk mitigation	Quality improvement
++	+++
+++ significant	++ average + low

# Finding the suitable service and financial instrument for each client: every financial advisor's most important service

International supervisory practice on Investment Suitability is distinguished by attention to detail and a high degree of differentiation. Regulations are following a global convergence trend, yet no detailed regulatory guidelines exist in Switzerland to date. The Federal Supreme Court ruling thus offers a suitable framework of reference for the duties of financial services institutions in the field of investment advice. The Federal Court has expressly identified the following obligations:

- ▶ Disclosing risk
- ▶ Interviewing clients on their degree of knowledge and risk tolerance
- ▶ Providing tailored advice
- ▶ Warning the client, if and when necessary

What is the appropriate way to fulfill these tasks? In this brochure, we summarize our view of the potential need for action in five topics:

- ▶ Client investment profile and product classification
- ▶ Risk disclosure and verifiability
- ▶ Portfolio diversification standards
- ▶ Concentration risks at institute level
- ▶ Investment adviser training

Dealing with these topics in the right way can significantly mitigate the risks facing your company and enhance the quality of your investment advice.

## Contact

Zurich

**Iqbal Khan, Partner, Financial Services**

iqbal.khan@ch.ey.com, tel. +41 58 286 42 54

**Roger Senteler, Financial Services, Advisory**

roger.senteler@ch.ey.com, tel. +41 58 286 33 76

**Christian Röthlin, Financial Services, Legal**

christian.roethlin@ch.ey.com, tel. +41 58 286 35 38

**Alessandro Lana, Financial Services, Risk**

alessandro.lana@ch.ey.com, tel. +41 58 286 42 71

Geneva

**Stéphane Muller, Partner, Financial Services**

stephane.muller@ch.ey.com, tel. +41 58 286 55 95

**Barbara Ofner, Financial Services, Legal**

barbara.ofner@ch.ey.com, tel. +41 58 286 32 07

**Matthieu de Wolff, Financial Services, Risk**

matthieu.dewolff@ch.ey.com, tel. +41 58 286 55 49

Lugano

**Mario Mosca, Partner, Financial Services**

mario.mosca@ch.ey.com, tel. +41 58 286 58 66

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