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Rt Hon Frank Fields LLP
Chair
Work and Pensions Committee
14 Tothill Street
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10 January 2018

Dear Mr Fields

Further questions on pension transfer advice

I write further to your letter of 18 December 2017. I confirm that I am more than happy to assist with the ongoing work on the British Steel Pension Scheme (BSPS).

I have prepared my detailed responses to your queries below. Please note that in preparing these responses I have taken advice and consulted with professional external Legal and Compliance advisers and my external Compliance adviser has provided assistance on the specific regulatory points included in my response below.

Question 1

You stated that you had meetings with "well over 300 clients, of which approximately a third decided to transfer out". To how many clients did you provide a personal recommendation to transfer?

All clients were given advice on the options available to them and which option, based upon their own personal needs, was the most appropriate for them.

In all cases, clients were advised that if a guaranteed regular income was their main priority, then they should stay in the BSPS. However, many wished to transfer out of the scheme for a number of other reasons. It was also explained to them that if they did choose to transfer out the scheme into a personal pension, then they would be taking on some element of investment risk.

Given the nature of the heavy work within the steel industry, many of the employees wished to draw their benefits prior to the BSPS normal retirement age (NRA) of 65. Taking benefits early attracted a penalty which was tiered according to the number of years to the scheme NRA when benefits went into payment. For example, a member would suffer a penalty of 18% of the pension they would receive at NRA if they started to draw their pension 5 years early, rising to a penalty of 30% if the benefits were taken 10 years early.

Many clients also had additional financial priorities such as early repayment of a mortgage using some of the available tax free cash.

Some clients prioritised being able to provide a better spouse's pension, which they were able to achieve by leaving the BSPS.

The improvement to the cash equivalent transfer basis was taken into account in the completion of the transfer value analysis for each affected client and a comparison of benefits from the BSPS and an alternative scheme was provided to every client for whom an assessment was undertaken.

With effect from 31 March 2017 all members of the BSPS became deferred members of the scheme thereby having no further accrual and only benefitting from future indexation of benefits. Their options later this year will either be to join BSPS 2 or to go into the Pension Protection Fund. BSPS 2 will have a higher normal retirement age than the original scheme and will have indexation linked to CPI rather than RPI.

I will provide more detail in response to question 9 below, but I am also very concerned that I provided client files to the FCA which included transfers from defined benefit occupational pension schemes as early as August 2016. I received no feedback that the FCA had any concerns about the files or the practices in operation within Active Wealth until they visited the company in July 2017. At that stage, I agreed not to recommend any non-standard assets to clients, but again no material concerns were raised about advice in relation to defined benefit transfers.

I have sought to co-operate fully with the FCA at all times and I would have made any changes the regulator considered necessary to the firm's procedures at that time if they had suggested and or required me to.

Question 2

What proportion of BSPS clients did you charge on a 'no transfer-no fee' contingent/conditional basis?

Active Wealth provides a range of options by which it can be remunerated for the regulated services it delivers to its clients, some of which operate on a contingent basis and others where payment is not predicated on the arrangement of a transaction for the client. All of the methods of charging are compliant with the adviser charging rules which were introduced by the Financial Conduct Authority (FCA) under the Retail Distribution Review (RDR) with effect from 1st January 2013.

The available options are as follows:

- Payment by fee – this is payable from the client's own funds rather than as a deduction from the pension fund and is **not** contingent on the arrangement of a transaction on the client's behalf by Active Wealth.

  The fee is structured on the basis of the level of individual(s) conducting the work and the time spent by each individual. To provide a fuller insight to the operation of the fee structure, the fees will vary according to whether the individuals involved are one or more of:

    i. Chartered Financial Adviser

ii. General Financial Adviser
iii. Paraplanner
iv. Administrator

- Payment for intermediation of a transaction – this is payable on a contingent basis and can be paid either from the client's own funds or by deduction from the investment amount involved.

  The rate of charge will vary according to the type of product and the amount invested.

  The company may, alternatively, agree a fixed fee with the client to avoid very large monetary amounts becoming due if the investment amount/pension fund is high.

  The payment options are set out clearly in our Client Agreement and the client has the freedom to select the payment method that he feels suits him best.

  I thought it may also help the Work and Pensions Committee if I provided a little more context to how Active Wealth alighted on the fee payment options by outlining the requirements of the FCA's rules in this regard.

  As I have already mentioned, the prohibition of payment by product providers of commission for retail investment products was introduced under the RDR on 1 January 2013. This initiative applies to retail investment products, so commission is still permissible under non-investment insurance products.

The FCA rule which requires the remuneration of financial intermediaries by adviser charging is COBS 6.1A.4R which is entitled "Requirement to be paid through adviser charges", and states:

A [authorised] firm must:

(1) Only be remunerated for the personal recommendation (and any related services provided by the firm) by adviser charges; and
(2) Not solicit or accept (and ensure that none of its associates solicits or accepts) any other commissions, remuneration or benefit of any kind in relation to the personal recommendation or any related service, regardless of whether it intends to refund the payments or pass the benefits in to the retail client; and
(3) Not solicit or accept (and ensure that none of its associates solicits or accepts) adviser charges in relation to the retail client's investment product or P2P (peer to peer) agreement which are paid out or advanced by another party over a materially different time period, or on a materially different basis, from that in or on which the adviser changes are recovered from the retail client.

Adviser charges can be applied either by charging the client an explicit fee, or by the deduction of the adviser charge from the amount of the investment being made by the client. In the latter case, it is common for the adviser charge to be "facilitated" by a product provider, and this is catered for under COBS 6.1A.7G, which states:

The requirement to be paid by adviser charges does not prevent a [authorised] firm from making use of any facility for the payment of adviser charges on behalf of the retail client offered by another firm or other third parties provided that facility complies with the requirements of COBS 6.1B.9R.

COBS 6.1B.9R deals with the "Requirements on firms facilitating the payment of adviser charges" and I can elaborate on the requirements of this rule and the associated regulatory guidance should it be of help to the Committee.

The most important feature of the rules on adviser charging is that product providers and fund managers cannot have any influence over the quantum of remuneration payable to financial intermediaries so they cannot, therefore, influence advisers' recommendation by offering enhanced rates of commission.

The availability of the facilitation provision is important, especially in the case of pension business where no funds can be withdrawn prior to the client reaching age 55. While a range of fee payment options are presented to a client, a majority of clients choose for the initial adviser charge to be deducted from their investment funds.

Over 90% of the BSPS clients chose to pay via a contingent basis.

Question 3

What is the a) highest and b) average transfer value that you handled in respect of BSPS clients?

The highest transfer value that Active Wealth handled in respect of BSPS clients was £790,404 and the average was £398,347.

Question 4

What is the a) highest and b) average fee you have received in respect of BSPS clients?

The highest fee Active Wealth has received in respect of BSPS clients is £1,500 and the average fee was £1,443.

Question 5

What proportion of clients are liable to pay ongoing fees?

Active Wealth's practice is to defer the application of any ongoing adviser charges for two years from the date on which the initial advice was provided. Given the initial advice to members of the BSPS was provided at the beginning of 2017, none of the former members of that scheme have paid an ongoing adviser charges.

I think it might also help the Committee to gain an insight into the FCA's rules on ongoing adviser charging.

The relevant rule in this context is COBS 6.1A.22R which states:

A firm must not use an adviser charge which is structured to be payable over a period of time unless (1) or (2) applies:

> *(1) The adviser charge is in respect of an ongoing service for the provision of personal recommendations or related services and:*
>
> > *(a) The firm has disclosed that service along with the adviser charge; and*
> >
> > *(b) The retail client is provided with a right to cancel the ongoing service, which must be reasonable in all the circumstances, without penalty and without requiring the retail client to give any reason; or*
>
> *(2) The adviser charge relates to a retail investment product or arrangement with an operator of an electronic system in relation to lending for which an instruction from the retail client for regular payments is in place and the firm has disclosed that no ongoing personal recommendations or service will be provided.*

In summary, the payment of an ongoing adviser charge must be predicated on the client agreeing to an ongoing advisory service from the intermediary. The client is under no obligation to accept such an ongoing service. If the client decides to accept an ongoing service, the adviser charge can either be paid directly by the client, or they can elect to have the charge deducted from their investment fund.

Moreover, having agreed to receive the service and to pay the ongoing charge, the client can cancel the service, and therefore the payment of ongoing adviser charges, without prior notice and without penalty.

Active Wealth has always complied with these rules in full.

Question 6

What range of investment vehicles did you offer to clients?

There are three key elements to the answer to this question, which I will deal with in turn.

(a) Pension wrappers

The choice of pension wrapper is based on what is most appropriate for the client. If the client has simple requirements and has limited funds and investment experience, a pension wrapper which permits a wider range of investments is unnecessary and, in such cases, we would recommend a personal pension from a large life assurance company such as Royal London.

However, if the client was a little more financially sophisticated, and had a larger amount to invest, perhaps requiring a greater level of diversification of investments, then a self-invested personal pension (SIPP) may be more appropriate.

Some people hold the view that SIPPs are higher risk products. However, they are personal pensions offering a wider choice of investments that can be held within them. Many of the pension wrappers offered by the large life offices, such as Aegon and Aviva, are SIPPs but their investment range is generally constrained to what are referred to as “standard assets” (see below).

SIPP providers we have used include Novia Fund Managers, Fidelity SIPP, Intelligent Money and Momentum Pensions.

Prior to the selection of any product or platform provider, or fund manager, we undertake due diligence on the firm to establish whether their offering meets high standards, including low charges. The aim of the due diligence process is to ensure that the package recommended to the client meets their objectives and is in their best interests.

(b) Investment funds

The inclusion of a fund manager, and specific investment funds, within the range we might recommend to clients is preceded by a rigorous programme of due diligence. Following modern portfolio theory, our aim is to select funds that offer strong risk-adjusted returns. This involves looking at the strategy and track record of the fund manager and the funds under consideration, and to analyse a range of metrics, including common measures of volatility, such as standard deviation, and of risk-adjusted returns, such as the Sharpe ratio. We also consider Sortino which is a variation of the Sharpe ratio which distinguishes downside volatility from overall volatility. It uses an investment's standard deviation of negative returns, often referred to as downside deviation or semivariance.

This information is widely available via organisations such as Morningstar and Financial Express.

We use a combination of passively and actively managed funds. Where we are considering actively managed funds, we assess three key metrics:

- Alpha – this measures the performance of a fund against an appropriate benchmark or market index, and is often referred to as the active return of an investment. The involvement of an active fund management service should result in performance that exceeds the benchmark
- Beta – Beta is a measure of the volatility of an investment in comparison with the market as a whole. A beta of 1 indicates that an investment's price moves with the market. A beta of less than 1 implies that the investment is less volatile than the market and a beta of more than one indicates that the price is more volatile than the market.
- R-squared – this assesses the extent to which the performance of a fund is attributable to the movements in a benchmark index.

When we assess passively managed funds, we consider tracking difference and tracking error.

- Tracking difference – this compares a fund's return to the performance of its underlying index over a period of time. It assesses how closely a passive funds tracks its index.
- Tracking error – this looks at the consistency of tracking difference over time, and is a measures that defines how consistent the return difference between a fund and its benchmark index has been.

These are technical measures and are not necessarily communicated in detail to clients. Instead, our analysis of funds and interpretation of a package of metrics is part of the service provided to clients and is therefore a component of the professional services offered by the company.

We have used funds provided by large insurers such as Royal London and portfolios managed by Gallium fund solutions using underlying UCITS funds managed by Newscape Capital Group.

There has been considerable comment, particularly in social media, about UCITS funds, and there seems to have been an attempt to conflate UCITS and UCIS, which are fundamentally different.

A UCIS is an acronym for an *Unregulated Collective Investment Scheme.* If a collective investment scheme is not authorised or recognised by the FCA, it is considered to be a UCIS. Such schemes are not subject to the same restrictions in terms of their investment powers and how they are run and can therefore present additional risk to those investing in them.

UCIS can only be promoted to some limited types of investor, including:

- Certified high net worth investors
- Sophisticated investors
- Self-certified sophisticated investors
- Existing investors in UCIS

Active has <u>not</u> recommended UCIS to <u>any</u> of its clients.

UCITS stands for *Undertakings for Collective Investment in Transferable Securities*. Such schemes are subject to a series of five EU Directives which provide a high level of investor protection. The most recent, UCITS V, was implemented in 2016 and strengthened the rules on the responsibilities of depositaries. The depositary acts as custodian and monitor or auditor of the fund. The latter part of the depositary's functions comprise:

- Monitoring cash flows;
- Ensuring that the dealing of units is carried out in accordance with national laws and the fund's rules; and
- Ensuring that the valuation of units is carried out in accordance with national laws and the fund's rules.

It is evident that there are very significant differences between UCIS and UCITS, with the legal and regulatory framework applying to the latter providing strong protection for investors.

(c) Investment platform

Many retail investments are managed on investment platforms and, as with other aspects of financial services, there are material differences between the costs, services and functionality of different platforms.

One of the platforms used by Active Wealth has been Gallium platform. Two of the reasons for its selection have been:

- Unlike with most platforms, there is no need to keep a percentage of the client's funds in cash to cover costs such as fund management charges. This practice creates a cash drag on the performance of the fund and impacts on the returns available to the client.
- From time to time, it is necessary to re-balance a portfolio to bring it back into line with the target asset allocation. For example, in a fund with a target allocation of 60% equities and 40% in fixed income, the equity portion of the fund might outperform the fixed income element and the proportions will change, with the value of the equity holding exceeding its 60% target, with a commensurate reduction in the fixed income. This is known as "portfolio drift" and can gradually result in the risk profile of the portfolio moving away from the risk appetite of the client.

  In these cases, it is necessary to re-balance the portfolio back to the 60/40 split. This involves selling equities and buying more fixed income stocks. This usually involves a part of the client's portfolio being held in cash for about a week while the sale and subsequent purchase transactions take place. This usually referred to as the client being "out of the market" and this has an impact on overall investment performance. The Gallium platform has overcome this effect and enables clients to remain fully invested at all times.

In conclusion, the approach has been to seek solutions which are shown by the due diligence process to offer real benefits to our clients, including former members of the BSPS.

Question 7

How did you assess suitability to provide stable income in retirement, with an appropriate level of risk, when recommending investments to clients?

The assessment of an investment fund with an appropriate level of risk matched to the client's risk appetite is a fundamental part of the advisory process that has been in place within Active Wealth, and has been a core requirement of the FCA's rules of assessment of suitability.

I will set out below the requirements of the FCA rules in this regard and then overlay this with the process operated by Active Wealth throughout the period in which advice was provided to members of the BSPS.

In the former case, I should point out that the rules to which I will refer below are those in operation during 2017. The Committee will no doubt be aware that an additional set of rules has been implemented in connection with suitability with effect from 3 January 2018 in order to comply with MiFID II and associated EU regulation. I will not be referring to these new rules in this response.

The relevant FCA rule in this context is COBS 9.2.2R which reads as follows:

(1) A firm must obtain from the client such information as is necessary for the firm to understand the essential facts about him and have a reasonable basis for believing, giving due consideration to the nature and extent of the service provided, that the specific transaction to be recommended, or entered into in the course of managing:

(a) Meets his investment objectives;
(b) Is such that he is able to bear financially any related investment risks consistent with his investment objectives; and
(c) Is such that he has the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio.

(2) The information regarding the investment objectives of the client must include, where relevant, information on the length of time for which he wishes to hold the investment, his preferences regarding risk taking, his risk profile, and the purposes of the investment.

(3) The information regarding the financial situation of a client must include, where relevant, information on the source and extent of his regular income, his assets, including liquid assets, investments and real property, and his regular financial commitments.

COBS 9.2.3R provides details of the information that must be captured in connection with the client's knowledge and experience of investments, as follows:

The information regarding the client's knowledge and experience in the investment field includes, to the extent appropriate to the nature of the client, the nature and extent of the service to be provided and the type of product or transaction envisaged, including their complexity and the risks involved, information on:

(1) *The types of service, transaction and designated investment with which the client is familiar;*
(2) *The nature, volume, frequency of the client's transactions in designated investments and the period over which they have been carried out;*
(3) *The level of education, profession or relevant former profession of the client.*

The reason for setting out the relevant rules is to provide some context to the ways in which Active Wealth has structured the process of determining a client's risk appetite, and to clarify the factors, such as the investment term and the client's knowledge and experience of investments, which are relevant to the selection of an appropriate fund.

When considering risk appetite, this is generally broken down into attitude to risk (ATR) and capacity for loss.

ATR focuses on a client's willingness to take risk which, in investment terms, is generally focused on the risk of financial loss resulting from the quality of the investment, the volatility of income and capital values from equities, and the ability of bond issuers to repay the amount lent to them at the end of the term of the investment (counterparty risk).

Capacity for loss is more associated with the impact of a fall in investment values on the client's lifestyle, and in this context account must be taken of the client's investment term, their position in terms of income and expenditure, and the assets and liabilities they hold, including liquid assets.

For determining ATR, Active Wealth has used proprietary software tools designed specifically for use in relation to retail clients. This is based on a series of psychometric questions and an underlying tool which analyses the responses provided by the client, conducts consistency checks to ensure that questions have been answered properly, and generates a rating for the client's ATR on a scale of 1 to 10, with 1 being risk averse and 10 being speculative.

The software also has a smaller number of questions on capacity for loss, and the answers to these are fed into the overall risk rating generated for the client.

The capacity for loss rating is "sense checked" against the information captured on the fact find regarding income and expenditure, assets and liabilities and investment term, and the risk rating is then discussed with the client to ensure that they are comfortable with the rating and the description of the typical investor to whom that rating would apply.

When selecting funds for BSPS clients, they have been treated as retail clients, and therefore are able to benefit from the highest level of protection under the regulatory regime. They are also treated as being of limited financial sophistication and the funds selected as being appropriate for them comprise standard mutual funds with a high level of liquidity and strong governance. In this latter regard, a number of BSPS clients have been placed into UCITS funds given the very robust regulation and governance associated with UCITS funds which, as mentioned earlier, are subject to a series of EU directives.

Wherever possible, Active Wealth clients are placed in funds which minimise the volatility of returns and which have a track record of producing the target level of returns the client is seeking.

When assessing how realistic the targeted income levels are given the size of the client's investment fund, investment term and risk appetite, Active Wealth takes account of research published by reputable firms such as Vanguard Investments, Morningstar and Financial Express.

In short, Active Wealth's approach has been to act in the best interests of its clients and to provide advice which is tailored to meet the client's investment objectives, their ATR and capacity for loss, and their investment term.

Question 8

How many transfers resulted in a marketing fee or other intermediation fee being paid by the investment company to yourself?

As noted in my response to question 2 above, since 1 January 2013, any payments of fees other than adviser charges, which must be agreed with the client, have been prohibited. I have outlined the company's charging structure above and all business written since January 2013 has been subject to adviser charging only.

These requirements apply equally to intermediaries, investment managers and product providers and Active Wealth has not received, nor been offered by the investment companies it has dealt with, any marketing or other intermediation fees.

Question 9

When were you first contacted by the Financial Conduct Authority (FCA) in connection with your provision of pensions advice to BSPS clients?

Active Wealth was first contacted by the FCA in connection with BSPS clients on 16 November 2017. However, the company was requested to provide its new business register, which included details of the types of transactions that had been arranged and, in the case of pension transfers, the ceding pension schemes. On 3 August 2016, the FCA requested various items, including and outline of the firm's advice/sales procedures and monitoring arrangements in relation to pension transfers and/or switches, including a flowchart of the whole advisory process. The company was also asked to provide 6 specific client files.

No feedback was received from the FCA on the information and files that had been submitted.

On 5 January 2017, the FCA requested a further six client files and an outline of the firm's procedures and monitoring arrangements, including a flow chart of the advisory process specific to switching pension arrangements into SIPPs.

The requested items were supplied on 19 January 2017 and the FCA confirmed receipt on 20 January 2017.

On 13 February 2017, the FCA asked for details of the underlying investments for the six clients whose files were submitted on 19 January 2017. The FCA also asked who selected the funds into which clients were invested and copies of the information provided to each client.

The FCA arranged a visit to Active Wealth on 20 and 21 June 2017, but this was postponed on the morning of 20 June 2017 and subsequently re-arranged for 17 and 18 July 2017. Following the visit, Active Wealth confirmed in writing its agreement not to recommend any non-standard assets to its clients. This confirmation was provided on 18 July 2017.

The processes that were in operation in mid-2016 were not commented on by the FCA until following the visit in July 2017. As a result, it was a complete shock for the FCA to intervene in the manner in which it has and to invite Active Wealth to apply for a voluntary variation of its permissions to cease providing any pensions advice. Active Wealth has always sought to cooperate fully with the FCA and continues to do so. Had the FCA raised any concerns in connection with the files supplied in August 2016, the relevant processes would have been amended.

I trust the information I have provided will be of assistance to the Committee in its work but if you need anything further, please do let me know and I will be happy to assist in any way I can.

Yours sincerely

Darren Reynolds
Active Wealth UK Limited