Pre-Reading for Monday 13 June Plenary Session 2

Case Study on Putting It All Together

IFIE Case Study – John Smith and Maia Sariman

[Note: This case study is a composite of actual case files to illustrate issues encountered by dispute resolution bodies handling investor complaints. The names and views of individuals, firms, regulatory bodies, and jurisdictions are not actual and should not be attributed.]

An International Investor Couple

John Smith is a UK national now resident in the Channel Islands after early retirement from a career in accounting in the UK. He spends each winter in South-East Asia with his spouse, Maia Sariman, who is from Malaysia. They married last year, a second marriage for both of them as their previous spouses had passed away in recent years. John and Maia have kept their financial affairs largely separate including their investment portfolios.

John Smith

In the aftermath of the global financial crisis, John experienced a significant decrease in the value of his investment portfolio which was largely in funds. He had previously complained to his independent financial advisor (IFA) in 2010 regarding the losses claiming that they appeared to have been too risky and volatile for his risk tolerance. The firm rejected his complaint and the complaint was then escalated to the financial Ombudsman in his jurisdiction at that time, the UK. The UK Ombudsman's initial assessment was that John's significant investment experience and medium risk tolerance did not support a conclusion that his investment portfolio was unsuitable although it was noted that some individual funds which were identified as medium risk in the disclosure documents filed with the regulator were quite complex and volatile which called into question the appropriateness of the “medium risk” description provided by the fund company in the disclosure documents. Despite this risk rating issue, the UK Ombudsman’s final conclusion was that John’s investment losses were due to market risk that he knowingly took and that the investments recommended for him were suitable for his significant investment knowledge and risk tolerance.

As a result of this experience, John’s investment portfolio was adjusted to be much more conservative and he became significantly more risk-averse. The problem this created is that his portfolio returns were consistently low and he wondered how he could increase his future investment returns without increasing the risk he feared assuming given his experience in 2008-2009.

More recently, John and Maia were spending time at a rented sea-side condo at a resort in another South-East Asian country. Sitting by the pool one evening, they befriended Tony from the UK who was visiting for a few weeks on vacation. The UK visitor was an investment professional and he appeared highly knowledgeable about markets and investment volatility. He engaged in interesting discussions with John and Maia about the financial world and the challenges facing both retirees and those approaching retirement. Low returns on John’s UK pension were discussed and Tony pointed out the pension rule changes that created an ability to withdraw up to 30% of his pension assets. In the course of a discussion about higher investment returns without increasing volatility, Tony suggested John look at some alternative investment opportunities which were either insulated from, or counter-cyclical to the market. John was intrigued and after some additional discussions and review of some analysis of returns provided by Tony, agreed to draw down a portion of his UK pension and invest USD 50,000 into an alternative investment. Another pension withdrawal of USD 50,000 John said would be needed within two years as he and Maia were planning to buy a condo locally and would need the funds for their down-payment. That amount was invested into an insurance policy that paid a fixed return better than John felt he could get elsewhere.

The alternative investment turned out to be an unlicensed investment vehicle involved in pooled US mortgage financing which subsequently failed, resulting in a complete loss of John’s investment. It was unclear whether or not the investment was a fraudulent scheme. There were no residual assets available to compensate investors and the principals of the investment firm were not locatable.

When John contacted the insurance company and sought to redeem his USD 50,000 policy, he was informed that there would be very high fees for early redemption including the payment of the administration fees that would be chargeable over the entire policy term of 10 years. This amounted to about 40% of the invested capital, or USD 20,000 of his investment of USD 50,000. The insurance policy clearly stated the liability for the administration fees and the penalties for early redemption of funds in the policy. However, given the short time horizon before John needed access to the invested funds, the 10-year policy with large costs associated with early withdrawal was clearly unsuitable. John admitted he did not read the policy carefully when her received it in the mail a couple of weeks after the sale was completed.

John argued that Tony had likely received a large up-front sales commission from the alternative investment company and the insurance company. Both of the firms refused to disclose information on Tony or the nature of his compensation for making the sale citing privacy considerations.

A detailed internet search showed that John's pool-side advisor Tony looked to be James Anthony Barker, who had been disciplined by the regulator in the UK for various breaches and was no longer licensed to sell securities. John said it had not occurred to him to check this through the internet. He asked how it was possible that this guy was still in the investment business.

A complaint was made to the local regulatory authorities who regretfully said it was not within their jurisdiction as the products and the advising individual, who was a UK national and resident, were not registered with them. There was no financial Ombudsman or other financial dispute resolution mechanism in that jurisdiction. John contacted the Channel Islands Financial Ombudsman (CIFO) in Jersey where he was resident. CIFO had an information-sharing arrangement with the appropriate financial Ombudsman in the other European jurisdiction where the insurance company was located. The complaint was passed over with the relevant information.

Upon investigation by the financial Ombudsman in the other European jurisdiction where the insurance company was a regulated entity and therefore a participant in the Ombudsman scheme, the insurance product sold was found to be legitimate with clearly disclosed terms and conditions but was clearly unsuitable for John's stated needs. The insurance company stood by the integrity of its product and denied any responsibility for the mis-selling of the insurance policy as a short-term investment. The firm admitted that it had booked the sale from Tony (with whom they had a relationship while he was a licensed IFA in the UK).

Maia Sariman

Maia has a significant investment portfolio that had been managed for many years by a portfolio manager who was a close family friend. He recently retired from the business and passed his book of business on to his son, Terry (adapted from Tariq) who had attended university and trained in finance in the US and had recently returned and obtained his license to sell securities and manage private investment portfolios with another investment firm. Maia's portfolio was transferred from the previous firm to Terry early last year (about 18 months ago) but Maia and Terry had not yet met. Maia did not pay close attention to her investments. Her deceased husband had taken care of their financial affairs but she was financially literate and kept a close watch on the markets and on the value of her overall portfolio. Maia's investment mandate required that she be invested conservatively to generate some income but to preserve her capital. One of the other provisions in the investment mandate that had been established for Maia's investment portfolio was the requirement that all of the investments be Sharia-compliant. This was critically important to Maia.

Maia's accountant was working through her financial affairs addressing the various circumstances caused by her late husband's passing several years before. In reviewing the detailed financial statements from the investment portfolios, he noted several investments that had performed very badly and that appeared to be too volatile and risky for Maia's low-medium risk conservative investment mandate.

Maia shared the investment statements with her husband John who also noted that some of the investments did not appear to be Sharia-complaint as he understood the requirements. He had been doing some reading on Sharia-compliant financial services and it had become an area of personal interest. When he shared his concerns with Maia, she was devastated. It appeared that the allegedly non-complaint investments had had been in the portfolio prior to the death of her former husband and certainly before the transfer of the accounts to Terry at the new investment firm.

Given Maia's distress and anger over the situation, John undertook to make a complaint on behalf of Maia. John quickly discovered that the former investment firm was no longer in business and had surrendered its investment license. The new investment firm which employed Terry refused any responsibility for the problems as they said they were the responsibility of the previous firm and the previous financial advisor.

The issue was escalated to the local financial dispute resolution body (similar to an Ombudsman). Terry was interviewed about both issues, the investment suitability and the Sharia-compliance in the portfolio. He indicated that the investment mandate included the provision of some income which, in the current low return environment, required the portfolio to take on significantly more risk to maintain the levels of annual income that had been generated previously. He noted that some higher risk investments had been made previously by the previous investment advisor and that, subsequent to the transfer of the account to him, he had continued to invest in some higher risk securities that offered the prospect of higher income to maintain the previous levels of income in the sustained low rate environment. Unfortunately, some of them had not performed as hoped and incurred significant losses, but Terry noted that the portfolio overall had produced reasonable income given the market. John was of the view that these higher risk investments were unsuitable and that any losses specifically associated with them should be compensated.

With respect to the Sharia-compliant investment mandate, Terry acknowledge he was aware of the mandate but said he had not done anything to the portfolio that changed its status after it was transferred in to him. The changes he made were all similar to the previous holdings and there had been no indication from Maia that she was unhappy with the current holdings at the time of the transfer. He also stated that he took a seminar in Sharia-compliant investing in the US before returning start his practice and said that there were no definitive guidelines on Sharia-compliance. His perspective is that the portfolio was reasonably compliant and that Maia was simply looking to manage the reputation risk associated with her and her former husband having any investments which could be perceived as non-compliant. From an overall portfolio return perspective, Terry felt that the portfolio had exceeded its benchmarks and therefore was a reflection of the superior service being provided by him and his firm.

<u>Questions</u>

1. As regulators and educators, what issues do you see arising from the case study?

2. What themes do you see in the case study that should be incorporated into investor education programming?

3. How can you see dispute resolution the regulatory role when facing such situations?

4. How do you see dispute resolution assisting with investor education?

5. How can we ensure going forward that the intelligence gathered through complaints is effectively leveraged for regulators and for investor education?