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# **Breakfast Briefing Series**

## **Reducing the Risks of Investment Product Mis-selling**

**21st April 2009**

# Reducing the Risks of Investment Product Mis-selling

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- ▣ Impact of the Financial Crisis – the domino effect!
- ▣ Causes of the Financial Crisis – de Larosière Group
- ▣ Learning from the Lehman's Minibond Crisis
- ▣ Steps to reduce the risk of mis-selling claims
- ▣ Handling Complaints
- ▣ Q & A

# Reducing the Risks of Investment Product Mis-selling

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## Impact of the Financial Crisis – the domino effect!

- ▣ Since July 2007, the world has faced/continues to face, the most serious and disruptive financial crisis since 1929.
- ▣ The value of listed companies has dropped more than €16 trillion =1.5 times the GDP of the EU.
- ▣ Sudden downgrade of credit ratings.
- ▣ Crisis in confidence in Autumn 2008 – large scale liquidity crisis.
- ▣ Investors have lost significant value – leading to increase in allegations of mis-selling.

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## Causes of the Financial Crisis – de Larosière Group

### **Report prepared by High Level Group on Financial Supervision in the EU – 25 February 2009**

[ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf) -

- ▣ Macroeconomic issues
- ▣ Risk Management
- ▣ Role of the Credit Rating Agencies
- ▣ Corporate Governance Failures
- ▣ Regulatory, Supervisory and Crisis Management Failures

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## Causes of the Financial Crisis – de Larosière Group

### **Macroeconomic Issues**

- ▣ Ample liquidity and low interest rates led investors to seek higher yields
- ▣ More innovative and complex products designed to offer improved yields, many combined with increased leverage.
- ▣ Greater risks taken but, but not properly priced.
- ▣ Financial Institutions engaged in very high leverage (on and off balance sheet) making them exceedingly vulnerable to even a modest fall in asset values.

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## Causes of the Financial Crisis – de Larosière Group

### **Risk Management**

- ▣ Failure to assess risk correctly by both firms and regulators due to misunderstanding the interaction between credit and liquidity and failure to verify fully the leverage of firms.
- ▣ Model based risk assessments underestimated the exposure to common shocks.
- ▣ Extreme complexity of structured finance products made proper risk assessment challenging.
- ▣ Lack of transparency – Little knowledge of either the size or location of credit risks.

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## Causes of the Financial Crisis – de Larosière Group

### **Role of Credit Rating Agencies**

- ❑ CRA's lowered the perception of credit risk by giving AAA rating to the senior tranches of structured products such as collateralized debt obligations.
- ❑ Conflicts of interest in the CRA's products structured to achieve a particular rating (Issuer pays model).
- ❑ Regulators required certain regulated investors to only invest in AAA - rated products – increased demand for such products.

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## Causes of the Financial Crisis – de Larosière Group

### **Corporate Governance Failures**

- ▣ Boards and senior management of firms didn't truly understand the characteristics of new, highly complex financial products in which they were dealing and seriously underestimated the risks they were running.
- ▣ Remuneration and incentive schemes within firm contributed to excessive risk taking by rewarding short term expansion of the volume of (risky) trades rather than the long term profitability of investments.

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## Causes of the Financial Crisis – de Larosière Group

### **Regulatory, Supervisory and Crisis Management Failures**

- ▣ Too much reliance placed on both the risk management capabilities of banks and of banks themselves and on the adequacy of ratings.
- ▣ Too much attention paid to individual firms and too little to the impact of general developments on sectors or markets as a whole.
- ▣ Failure to spot the degree to which a number of EU based institutions had accumulated off balance sheet constructions.
- ▣ Strong international competition among financial centers contributed to national regulators and supervisors being reluctant to take unilateral action.

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## Learning from the Lehman's Minibond Crisis

- ▣ On 15/09/08 Lehman Brother Holdings (the 4<sup>th</sup> largest investment bank) filed for bankruptcy protection.
- ▣ In Hong Kong Lehman had been a major arranger of a particular structured product – a callable credit linked note marketed under the name of minibond since 1992.
- ▣ These notes were structured with underlying collateral so that capital could be repaid at maturity.
- ▣ The severe deterioration of the global market in 2008 meant that the collateral lost significant value, in some cases all of its value.

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## Learning from the Lehman's Minibond Crisis

- ▣ Following the failure of Lehman Brothers it became clear that the Lehman minibond was widely sold in Hong Kong via banks and brokers to a broad range of the investing public (approximately 40,000 investors in Hong Kong).
- ▣ Volume of complaints to both the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority (HKMA) escalated rapidly as investors came to realise that they had made significant losses on products that they had considered low risk.
- ▣ By December, 2008 approximately 27,000 complaints had been received by the SFC, the HKMA and other bodies.

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## Learning from the Lehman's Minibond Crisis

In December 2008, the SFC issued a report to the Financial Secretary on the issues raised by the Lehman minibond crisis.

[www.sfc.hk/sfc/doc/EN/general/general/lehman/Review%20Report/Review%20Report.pdf](http://www.sfc.hk/sfc/doc/EN/general/general/lehman/Review%20Report/Review%20Report.pdf) -

### **Initial findings by SFC –**

Of the 27,000 complaints received it was found that the most common generic complaints were:

- ▣ Misrepresentation;
  - Products wrongly presented as low risk alternative to deposits;
  - Risks and complexity not properly explained.

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## Learning from the Lehman's Minibond Crisis

### **Initial findings by SFC –**

#### ▣ Suitability

- Investors claiming that Brokers and banks failed to carry out a proper customer due diligence.
- Inexperienced retail investors left holding products not suitable to their investment profile.

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## Learning from the Lehman's Minibond Crisis

### Initial findings by SFC –

#### ▣ Product Disclosure

-SFC to determine whether information disclosed in the product documentation by the product issuer was sufficient to enable a reasonable person to make an informed decision.

-Clients asked to sign a statement that they “had read and understood the prospectus”. Complainants said that while they signed this statement they did not either read or understand the document.

-Per SFC, Intermediaries under an obligation pursuant to the code of conduct to explain the nature and risks of the product they are selling despite obtaining apparent confirmation that clients had read and understood the relevant prospectus.

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## Learning from the Lehman's Minibond Crisis

### Initial findings by SFC –

#### ▣ Product Description

-Concern expressed that product was so complex that an “average“ investor would have found it difficult to understand and it should not have been authorised for sale to the public.

-The name minibond could legitimately be described as debenture bond, structural bond, note, credit linked note or derivative. However, the product was marketed under the name minibond implying it was as safe as a high grade corporate or government bond.

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## Learning from the Lehman's Minibond Crisis

### **Next steps for the SFC in their investigation**

SFC will look at whether the Intermediaries:

- ▣ Acted with due skill, care and diligence, in the best interests of its clients and the integrity of the market.
- ▣ Knew the client – the clients financial situation, investment experience and investment objectives.
- ▣ Concluded a thorough analysis before providing advice and recommendations.
- ▣ Ensured suitability of the recommendation for that client.
- ▣ Satisfied itself that the client understood the nature and risks of the products.
- ▣ Assessed that client had sufficient net worth to assume the risks and bear potential losses of trading in the products.

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

- ▣ Corporate Governance and Remuneration Structure
- ▣ Internal Risk Management
- ▣ Product Development and Disclosures
- ▣ Sales Team
- ▣ Client Classification
- ▣ Assessing suitability and appropriateness
- ▣ Compliance Review and Follow up

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Corporate Governance and Remuneration Structure**

De Larosière Group identified weak Corporate Governance as a contributor to current financial crisis. Remuneration structure key issue. Group have recommended that:

- ▣ Compensation incentives are aligned to shareholder interests and long term firm wide profitability.
- ▣ Bonuses are assessed over a multi-year framework (5 years) – spread out the actual payments of the bonus through the cycle and deduct any potential losses during the period.
- ▣ Bonuses are not guaranteed in advance.
- ▣ These rules are applied to both proprietary traders and asset managers.

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Corporate Governance and Remuneration Structure**

FSA's Draft Code of Practice on remuneration policies:

- ▣ Draft code issued by FSA on 26/02/09.
- ▣ Code sets out 10 specific principles which are relevant to all FSA regulated firms dealing with governance, measurement of performance for the calculation of bonuses, etc.
- ▣ Per the draft code firms should not assess performance solely on the results of the current financial year and instead should be assessed on long term performance.
- ▣ Remuneration policies must be aligned with sound risk management.

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Corporate Governance and Remuneration Structure**

Irish Government seeking a remuneration ceiling of €500,000 for bankers:

- ▣ Minister for Finance has written to financial institutions seeking a salary cap of €500,000 or the amount recommended by the Covered Institutions Remuneration Oversight Committee, whichever is the lesser.
- ▣ Deviations from the above cap subject to the Minister's agreement.

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Internal Risk Management**

- ▣ Risk management function within financial institutions must be made independent and responsible for effective independent stress testing.
- ▣ Senior risk officers should hold a very high rank in the company hierarchy.
- ▣ Internal risk assessment and proper due diligence must not be neglected by over reliance on external ratings.

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Product Development and Disclosures**

- ▣ Risk assessment of product complexity.
- ▣ Involve the Compliance Function in the product development process to assess if suitable for intended market.
- ▣ Consider impact of different markets conditions -if volatile performance – is this clear in product literature?
- ▣ Product Description e.g. Bond suggests low risk – is it accurately described - remember Lehman minibond.
- ▣ Product literature – has it been reviewed/signed off by the Compliance Function to ensure appropriate disclosures are included.

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Sales Team**

- ▣ Does the Sales team understand all the mechanical aspects of the products that they are selling, including all the risks?
  - Compulsory internal training sessions;
  - Sign off by senior management that individuals in the sales process understand the product;
  - Sales staff hold suitable qualifications e.g. Minimum Competency Requirements when selling retail financial products to consumers.

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Client Classification**

#### MiFID Firms

- ▣ All clients to be notified of their categorization
- ▣ Retail v's Professional v's Eligible Counterparty

#### Non MiFID Firms – Consumer Protection Code

- ▣ Consumer v's Non Consumer
- ▣ Regulated firm must maintain a list of all customers who are consumers and are subject to the Code

Greater level of protection afforded to Retail clients/consumers.

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Assessing suitability and appropriateness**

#### MiFID Firms

- ▣ Assess financial situation
- ▣ Assess investment objectives
- ▣ Assess level of knowledge and experience

#### Non MiFID Firms – Consumer Protection Code

- ▣ Know the consumer – before providing a service gather and record sufficient information from the consumer (Factfind)
- ▣ Suitability – having regard to facts disclosed by consumer ensure product or service offered to consumer is suitable.

#### MiFID and Non MiFID firms

- ▣ Is this step (assessing suitability and appropriateness) fully documented for each relevant client?

# Reducing the Risks of Investment Product Mis-selling

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## Steps to reduce the risk of mis-selling claims

### **Compliance Review and Follow up**

- ▣ Review of internal manuals, rules and procedures for compliance with requirements for selling products (particularly complex) to retail investors.
- ▣ Analysis of gaps between what is required and what is being done in practice by sales staff with retail sales and on complaints handling.
- ▣ Provide feedback to senior management/Board of Directors.

# Reducing the Risks of Investment Product Mis-selling

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## Handling Complaints

- ▣ Understanding your responsibilities-
  - Non MiFID firms
  - MiFID firms
- ▣ Who can the Financial Services Ombudsman help?
- ▣ Understanding the role of the Financial Services Ombudsman.
- ▣ Right to appeal the Ombudsman's findings.
- ▣ Key considerations for Financial Service providers.

# Reducing the Risks of Investment Product Mis-selling

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## Handling Complaints

### **Understanding your responsibilities - Non MiFID firms**

#### Consumer Protection Code

-Applies to Credit institutions, insurance undertakings, insurance and mortgage intermediaries and investment business firms when providing Non – MiFID services.

-Chapter 1- General Principles – a regulated entity must ensure that in its dealings with customers it corrects errors and handles complaints speedily, efficiently and fairly.

-Chapter 2 – Common Rules – sections 46 – 48 sets out specific guidance for a complaints handling procedure:

- ▣ Have a written procedure for handling complaints.
- ▣ Acknowledge each complaint in writing within 5 business days of receiving complaint.
- ▣ Advise complainant who in firm is responsible for handling complaint.

# Reducing the Risks of Investment Product Mis-selling

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## Handling Complaints

### **Understanding your responsibilities - Non MiFID firms**

- ▣ Provide regular written updates on progress (at intervals not greater than 20 business days).
- ▣ Attempt to investigate and resolve a complaint within 40 business days.
- ▣ Where not resolved within 40 business days provide anticipated timeframe.
- ▣ Advise complainant of outcome of investigation within 5 business days of completion of investigation.
- ▣ Inform the complainant of the right to refer the matter to the Financial Services Ombudsman.
- ▣ Offer the consumer the opportunity to have a verbal complaint treated as a written complaint.
- ▣ Maintain up to date records.

# Reducing the Risks of Investment Product Mis-selling

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## Handling Complaints

### **Understanding your responsibilities – MiFID Firms**

Regulation 38 of the MiFID regulations requires an investment firm:

- ▣ To maintain effective and transparent procedures for the reasonable and prompt handling of complaints received from RETAIL clients or potential RETAIL clients.
- ▣ Keep a record of each complaint and the measures taken for the resolution of the complaint.

# Reducing the Risks of Investment Product Mis-selling

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## Handling Complaints

### **Who can the Financial Services Ombudsman help?**

- ▣ All personal customers of financial services;
- ▣ Limited companies with turnovers of less than €3 million;
- ▣ Charities, clubs, trusts and partnerships.

**Non MiFID firms** – clients classed as consumers.

**MiFID firms** – clients classed as Retail.

# Reducing the Risks of Investment Product Mis-selling

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## Handling Complaints

### Who can the Financial Services Ombudsman help?

#### Ombudsman Workload

	<u>2008</u>	<u>2007</u>
Total Complaints Received	5,950	4,374
Complaints about Investment issues	1034	400
% of Total Complaints	17.4%	9%

Of the 1,600 complaints received in the last quarter of 2008, 62% of resolved cases were to the benefit of customer.

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## Handling Complaints

### **Understanding the role of the Financial Services Ombudsman**

- ▣ Lodging a complaint
- ▣ Mediation
- ▣ Investigation
- ▣ Finding
- ▣ Appeal
- ▣ Redress
- ▣ Refusal to co-operate

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## Handling Complaints

### **Understanding the role of the Financial Services Ombudsman**

#### *Lodging a complaint -*

- ▣ Individual contacts Ombudsman about a complaint;
- ▣ Ombudsman issues a complaint form to the individual;
- ▣ Individual to return complaint form to Ombudsman within 14 days;
- ▣ Ombudsman assesses complaint form and determines whether it falls within the remit of the bureau;
- ▣ If within Ombudsman's remit, complainant advised to write to provider outlining his complaint and requesting a final response;
- ▣ Provider must issue the final response (outlining its position in relation to the dispute) to the complainant within 24 working days;
- ▣ If complainant not satisfied with the final response from provider it must submit the final response to the Ombudsman within 15 working days of the provider issuing same.

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## Handling Complaints

### **Understanding the role of the Financial Services Ombudsman**

#### *Mediation -*

- ▣ The Ombudsman will assess the complaint form and the final response letter issued by the provider;
- ▣ Option of mediation will be offered to both parties by the Ombudsman as a means of resolving the matter;
- ▣ If mediation is not availed of or is unsuccessful then a formal investigation by the Ombudsman will begin.

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## Handling Complaints

### **Understanding the role of the Financial Services Ombudsman**

#### *Investigation -*

- ▣ Ombudsman will issue a series of questions to the provider;
- ▣ Provider must answer these questions and provide relevant support material to allow the Ombudsman adjudicate upon the complaint within 20 working days;
- ▣ If supplementary information required, the 20 working days may be extended;
- ▣ The response and documents will be copied to the complainant who will be given 10 working days to submit any observations;
- ▣ Any complainant observations will be copied to the provider who will be given 5 working days to submit any further observations;

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## Handling Complaints

### **Understanding the role of the Financial Services Ombudsman**

#### *Investigation -*

- ▣ All circumstances surrounding the complaint will then be examined by the Ombudsman;
- ▣ After reviewing the evidence the Ombudsman will consider whether an oral hearing is necessary;
- ▣ If an oral hearing is held then oral evidence given under oath at that hearing will be reviewed together with the documentary evidence;
- ▣ Ombudsman will issue a finding to both parties.

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## Handling Complaints

### **Understanding the role of the Financial Services Ombudsman**

#### *Finding -*

▣ The finding of the Financial Services Ombudsman is legally binding on both parties, subject only to appeal by either party to the High Court.

#### *Appeal –*

▣ A party has 21 calendar days from the date of the finding in which to appeal to the High Court.

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## Handling Complaints

### **Understanding the role of the Financial Services Ombudsman**

*Redress -*

- ▣ The Ombudsman can direct the provider to do one or more of the following:
  - ▣ Rectify or change the conduct complained of or its consequences;
  - ▣ Provide reasons or explanations for that conduct;
  - ▣ Change that practice;
  - ▣ Pay compensation up to a maximum of €250,000 or €26,000 annuity;
  - ▣ Take any other legal action.

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## Handling Complaints

### **Understanding the role of the Financial Services Ombudsman**

*Refusal to co-operate -*

- ▣ Ombudsman has extensive legal powers to require the financial services provider to provide information;
- ▣ Includes the power to require employees to provide information under oath;
- ▣ If necessary Ombudsman can enter the providers premises and demand the production of documents;
- ▣ Court order can be sought for non compliance;
- ▣ Anyone who obstructs the Ombudsman commits an offence and is liable to a fine up to €2,000 or imprisonment or both.

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## Handling Complaints

### Right to appeal the Ombudsman's findings

#### *Enfield Credit Union vs Davy Stockbrokers - Complaint*

Credit Union acting on advice of Davy's invested €1m in wrapper insurance bonds (perpetual bonds). The Credit Union lost €1m of its members money.

#### Issues-

- ▣ Lack of disclosure – Credit Union alleged that Davy's failed to make adequate disclosure of relevant material information relating to the bonds – the fact they were perpetual and sub-ordinated.
- ▣ Unsuitable – Credit Union claimed the Investment was unsuitable given its attitude to investment risk and given the Credit Union's investment policy is firmly based on capital guarantee at an identifiable date in the future.
- ▣ Credit Union wanted Davy's to buy back the bonds at cost price.

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## Handling Complaints

### **Right to appeal the Ombudsman finding**

#### *Enfield Credit Union vs Davy Stockbrokers Complaint*

##### Ombudsman finding

- ▣ Davy's failed to advise the Credit Union of the risk of the possibility of total loss of capital;
- ▣ Davy's failed to point out to the Credit Union that the bonds were outside the ordinary type of investment typically made by the Credit Union;
- ▣ Davy's should have been conscious that the Credit Union investment committee members placed their utmost faith in the broker and in the main were not financial or investment experts;

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## Handling Complaints

### Right to appeal the Ombudsman finding

#### *Enfield Credit Union vs Davy Stockbrokers Complaint*

#### Ombudsman finding (cont'd)

- ▣ All three members of the Credit Union investment committee admitted on oath that they blindly signed the application form and did not even read the brochure or the conditions which included a warning that the investment could be worthless;
- ▣ The Ombudsman found that under the circumstances that the Credit Union and Davy's must each bear 50% of the €1M loss and directed Davy's to refund a sum of €500,000 to the Credit Union and refund all fees and commissions.

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## Handling Complaints

### **Right to appeal the Ombudsman finding**

*Enfield Credit Union vs Davy Stockbrokers* Complaint

Davy's appeal of the Ombudsman finding

Following the Ombudsman ruling on the 21/01/08, Davy lodged a notice of appeal to the High court against the ruling:

- ▣ Requesting a review of the Ombudsman decision;
- ▣ Challenging the authority of the Ombudsman;
- ▣ Requesting a judicial review to impugn the Ombudsman decision on the grounds that the Ombudsman had misconstrued his powers under the statute and had fallen into unconstitutional procedures.

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## Handling Complaints

### **Right to appeal the Ombudsman finding**

#### *Enfield Credit Union vs Davy Stockbrokers Complaint*

#### High Court Decision

- ▣ On the 30 July 2008, Mr. Justice Charleton delivered his judgment whereby he quashed the Financial Services Ombudsman's decision made on the 21/01/08 in relation to the Enfield Credit Union complaint;
- ▣ Directed the Ombudsman to conduct a fresh investigation into the complaint in line with procedures outlined by the judge.

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## Handling Complaints

### **Right to appeal the Ombudsman finding**

#### *Enfield Credit Union vs Davy Stockbrokers Complaint*

#### Ombudsman's appeal to the Supreme Court

- ▣ On the 26 August, 2008, the Financial Services Ombudsman initiated an appeal in the Supreme Court against the High Court judgment that quashed his ruling in a complaint by Enfield Credit Union against Davy Stockbrokers.
- ▣ The case is due to be heard by the Supreme Court on 20 May, 2009.
- ▣ It is understood that the Financial Services Ombudsman will shortly introduce revised procedures in light of the High Court judgment.

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## Handling Complaints

### **Key considerations for Financial Service Providers**

- ▣ Review of complaints procedures
- ▣ Dealing with actual complaints
- ▣ Review Professional Indemnity Insurance

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## Handling Complaints

### **Key considerations for Financial Service Providers**

*Review of complaints procedures -*

- ▣ Written policy;
- ▣ Adhere to timelines as specified in the Consumer Protection Code/MiFID as appropriate;
- ▣ Understand the Financial Services Ombudsman process;
- ▣ Staff Training.

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## Handling Complaints

### **Key considerations for Financial Service Providers**

*Dealing with actual complaints -*

- ▣ Specific individual responsible for managing complaint;
- ▣ Adhere to timelines;
- ▣ Record keeping;
- ▣ In responding to complaint – stick to the facts and only say what you can support;
- ▣ Involve the Legal Department;
- ▣ Be professional, and don't get personal.

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## Handling Complaints

### **Key considerations for Financial Service Providers**

*Review Professional Indemnity Insurance -*

- ▣ Understand what is Covered
  - ▣ Negligent act, error or omission.
- Review Exclusions
  - Client loss in investment value due to normal or abnormal market trends due to investment advice given by Insured.
- Review Conditions
  - Insured shall not admit liability for or settle a claim without Insurer written consent.
  - Give notice in writing as soon as possible of any claim made by/against Insured.

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## Last Word

- ▣ In the current climate the number of mis-selling allegations is likely to increase.
- ▣ We would recommend that Firms review their procedures and controls to ensure that adequate preventative measures in place;
  - ▣ Corporate Governance
  - ▣ Risk Management
  - ▣ Robust and Compliant Sales Process
- ▣ In addition we would recommend that Firms review their claims handling procedure to ensure complaints are identified and dealt with in a timely manner.

# Contact

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## Q & A

## Contact

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