Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

Telephone: 020 7066 9346
Email: enquiries@fs-cp.org.uk

Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

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By email: dp21-01@fca.org.uk

Dear Sir/Madam

Financial Services Consumer Panel (the Panel)'s Response to the FCA's consultation DP 21/1: Strengthening our Financial Promotion rules

The Panel welcomes the opportunity to respond to how the FCA can strengthen its financial promotions rules for high-risk investments and firms approving financial promotions.

The Panel is also pleased with the proposed consumer testing of the various proposals set out in the paper and that the FCA will use behavioural insights to set policy that will achieve the best outcomes for consumers. We would further encourage the FCA to develop a panel with a broad spread of representative consumers with which they can test some firms' financial promotions. The FCA should elicit feedback as to how this panel perceives the promotion, the product, the firm and the potential risks, benefits and opportunities. The FCA could link specific elements of the promotion with each perception. This would give an ongoing test for how promotions are developing and how words, phrases, imagery and labelling impact consumers' choices.

There is clear evidence that promotions which, under the rules, should be limited to a certain audience are being presented, either intentionally or unintentionally, to other investors. Issuers appear to be using a method of stating that the advert is only intended for 'sophisticated investors' to sidestep the regulation. We therefore support the proposals to strengthen rules to capture those high-risk investments that may otherwise avoid regulation.

We believe the current approach of self-certification and the current definition of 'high net worth' to be inappropriate. Neither the current income level nor the value held in net assets really reflects a consumer's ability to sustain significant loss. We note that the FCA's definition of high net worth is more stringent in the mortgage market, than the investment market, and would encourage the FCA to consider whether a common industry definition that encompasses both the mortgage and investment markets might provide greater clarity. We do not believe a self-certification route is appropriate as this may enable consumers to unwittingly invest in a fund that is not appropriate for them. We would therefore suggest that a different solution be used to ensure that distribution is better targeted and managed.

We do not feel that investing is right for all consumers, but for those who do choose to engage in the market, we set out our vision for how the market should function in our response to the FCA's call for input on consumer investments. The foundation of this vision is firms having a duty to act in the best interests of their customers. This would make the firm responsible for the appropriate distribution of high-risk investments

including the marketing, labelling and comparability of different investment options, as well as consumers' overall suitability for and understanding of the products which they invest in. This would create a market where:

- more of the population with investible assets, and where the decision is right for them, make an active and informed choice to invest, so maximising their own returns and supporting the real economy;
- the information disclosed to potential investors is designed in a way that will allow them to make effective decisions, and to compare the risks and rewards not only of different options for a given product type, but also of different products.
- it is not possible to use regulatory arbitrage to circumvent rules designed to protect consumers;
- there is a common industry-wide definition of consumer segments (such as 'high net worth', 'novice' or 'able to sustain losses'), which is used to inform product design, set purchasing channels, target marketing and ongoing engagement.
- information, education, guidance and advice is readily available and tailored to the consumer to ensure they are supported in taking decisions both pre-investment and on an ongoing basis. This will require the re-engineering of current thinking to better integrate these aspects together and blend them throughout the customer's investment life-cycle. Only in this way will trust be established and consumers supported through what is an inherently complex set of decisions;
- the use of guidance or advice should be the gateway to anything other than a range of default-based, simple, tax-efficient investments. There should be better alignment of the experiences across pension based and non-pension-based investments with regard to the use, and availability, of defaults, pathways and 'universally suitable' solutions;
- the use of client self-certification must cease.
- products must be better designed, labelled and described to enable consumers to better understand fully the opportunities, risks and costs involved and easily compare these across options; and
- when harm does occur, there must be easily accessible and efficient redress and compensation solutions. The FSCS proposition in retail investments needs a fundamental and radical re-think to ensure it remains appropriate and is sustainable in the long term.

The entire consumer journey must be developed in a way that takes them through all the relevant information, tools, guidance and education prior to the investment decision. Firms may, as they do currently, choose to ask consumers to confirm that they have read and understood the information. However, we do not believe this removes the firm's duty of best interest with regard to the consumer, and the firm should carry the responsibility and accountability for the appropriateness of the sale of such higher risk investments.

Our responses to the questions posed in the discussion paper are included at Annex A below.

Yours faithfully

Wanda Goldwag

Chair, Financial Services Consumer Panel

Annex A – Responses to discussion paper questions

Q1: Please provide any data related to: a. the number of consumers who currently hold high-risk investments, the amount they hold and the type of high-risk investments they hold b. the number of issuers of high-risk investments, the amount they issue and the type of high-risk investments they issue.

No comment.

Q2: a. Are there any investments which are not currently subject to marketing restrictions which should be?

b. If yes, what is the investment and what level of restriction should apply?

c. Please explain your answer, including providing evidence of harm.

We have no comment on the specific types of investment not currently subject to marketing restrictions. However, it is important to note that around half of queries to the FCA's Supervision Hub currently relate to either firms or products not regulated by the FCA. This emphasises the importance of ensuring that the regulatory perimeter is set effectively, and communicated to investors in a way they understand, in order to avoid harm. The increasing prevalence of unregulated instruments such as cryptoassets, which carry no protection, further highlights the importance of consumers understanding where the perimeter is drawn and what this means for their investments.

Q3: a. Should there be changes to how certain types of investments are currently classified for the purposes of our financial promotion rules to prevent arbitrage in the context of our SIS rules?

b. If yes, what changes are needed?

c. Please explain your answer, addressing the issues we identify in paragraphs 3.20 to 3.25 where appropriate.

We support proposals that help eliminate regulatory arbitrage. Products that have similar functions and risks should be subject to the same rules, in order to allow consumers to make effective decisions.

Q4: a. Are there any other features of an investment which means they are generally inappropriate for retail investors and should be subject to a mass-marketing ban?

b. If yes, what are the features?

c. Please explain your answer, addressing the issues we identify in paragraphs 3.26 to 3.28.

The more complex the product, the harder it is for consumers to understand and therefore there is a greater likelihood of risks and loss materialising which the consumer didn't expect. These types of products can include, among other things:

- investments with lower liquidity (such as unlisted companies or property/infrastructure type funds);
- investments with high volatility or risk;
- investments with significant exposure to other types of risk (such as exchange rate risk);
- leveraged investments (where the potential for loss may hugely outweigh the possibility for growth);

- any product where the amount of money at risk in the event of any losses could be more than the capital invested; and
- investments where the price is affected by more than just the movements of the underlying net asset value (NAV).

Q5: a. Should we change the scope of securities covered by our RRS definition for the purposes of the financial promotion rules?

b. If yes, how should the scope be changed?

c. Please explain your answer, addressing the issues we identify in paragraphs 3.29 to 3.36.

We support changes that will help ensure that products with similar risk profiles and characteristics are treated in the same way. This will reduce the scope for regulatory arbitrage and consumer harm. Given the risks associated with liquidity, we consider that it would be sensible to ensure that the definition of 'readily realisable securities' is changed to ensure that there is a requirement that they should be regularly traded. While this will not completely eliminate liquidity risk, as liquidity can dry up at times of market stress, it would help minimise the potential for such risks to crystallise.

Q6: Please provide any data you have about the potential impact of any changes discussed in chapter 3. For example: the number of consumers, issuers, firms and investments which might be impacted; the potential costs and benefits of any changes.

No comment.

Q7: a. Do you think more requirements should be placed on firms to ensure the accurate categorisation of retail clients?

Yes.

b. If yes, what requirements should be introduced?

c. Please explain your answer, addressing the issues we identify in paragraphs 4.12 to 4.18.

The Panel believes that investing is not necessarily the right solution for everyone. Whilst it can offer better returns than cash-based savings, it comes with additional risk and complexity.

This means that it is important that regulatory rules designed to ensure that only consumers that have the capacity to bear significant risk are offered the opportunity to invest in riskier products. To achieve this, five things need to happen:

1. firms need to bear greater responsibility for ensuring that people investing in their products meet the appropriate criteria;
2. the definitions used to determine which consumers have the capacity to bear risk need to be tightened and improved. For example, the definition of a high net worth individual in the mortgage market (under MCOB) is: "a customer with an annual net income of no less than £300,000 or net assets of no less than £3,000,000, or whose obligations are guaranteed by a person with an income or assets of such amount." In contrast, the definition of high net worth in the retail investment market (where arguably risks might be greater) is someone with an annual income of £100,000 or more and net assets (albeit not including property) to the value of £250,000 or more. It would be helpful for the FCA to review whether these definitions will still provide an appropriate level of

protection, as well as whether a common industry definition that encompasses both the mortgage and investment markets might provide greater clarity;

3. the use of self-certification should cease. The responsibility for determining whether consumers are high-net worth and sophisticated must rest with the firm.
4. the FCA needs to ensure that the rules in place will provide sufficient flexibility to catch new channels serving self-directed investors as these channels emerge. The BritainThinks research, cited in para 4.6 of the discussion paper, provides a compelling case for the need for this, with, for example, 45% of self-directed investors not viewing 'losing some money' as a potential risk of investing, and 59% claiming that a significant investment loss would have a fundamental impact on their lifestyle; and
5. consideration needs to be given to the option of restricting investments to an appropriate proportion of liquid assets, not just 10% of net assets as set out in para 4.16. Consumers may have greater capacity to absorb losses associated with their liquid assets, so if their financial, non-pension assets are primarily in illiquid products and assets, any need to realise these assets in order to deal with losses elsewhere may lead to potential harm.

More generally, there is little segmentation of consumers on a consistent basis, and what does exist has mainly been developed on a provider by provider basis. The market currently lacks a well-thought through, common, set of consumer profiles (or segments) that better describe and define which consumer groups may, or may not, benefit from investing and which type of products and services are more appropriate for each segment. We would welcome debate between the FCA, the Investment Association (IA), providers and consumers groups that would add clarity in this area and set some common parameters for these consumer profiles. We believe the result of this would be better informed and designed solutions targeted at the appropriate consumer profiles leading to a better likelihood of a positive outcome for investors.

Even with this approach, for many consumers, especially savers looking at investment products for the first time, the range of products (accounts/wrappers/platforms) and investments can prove confusing and daunting. We have heard consumers tell of the frustration and confusion when, having gone through a process and the steps required to open 'an account' (such as an ISA) they are then presented with a further journey and set of decisions to select the investments (both the type of investment, such as stocks or funds, and then the actual investment itself) to be placed into the account.

The Panel envisages a market where the consumer is presented primarily with the products and services that are both appropriate and designed for them, and is supported by education and guidance to help them through a simple account opening and investment-choosing steps. The spectrum of products could range from simple tax-efficient or ISA accounts leveraging risk-based, well-defined and diversified default investments right through to the more esoteric, complex and risky investments sought by sophisticated, often wealthy, investors. Each consumer would only be presented with the part of the spectrum appropriate and relevant for them.

Q8: a. Do you think changes should be introduced to help consumers better categorise themselves?

b. If yes, what changes should be introduced?

c. Please explain your answer.

Ideally the categorisation of consumers should be based on hard evidence and an agreed set of definitions. As such, we would support a move away from self-certification. Instead, firms should be responsible for the categorisation.

Q9: a. Do you think the risk warnings we introduced for SISs should be applied more broadly?

Yes.

b. If yes, what investments should they apply to?

c. Please explain your answer, addressing the issues we discuss in paragraphs 4.27 to 4.33.

The Panel supports the use of risk warnings that use plain English, for example warning about the risk of losing money, rather than 'capital at risk'. This type of language will help boost understanding, as has been demonstrated by the testing undertaken by the Warwick Business School[1].

The Panel would support extending such warnings more broadly, to cover all situations where there is a risk of losing money. Behavioural economics teaches us that most people tend to place a much higher weight on potential losses than potential gains, meaning potential gains need to be significantly larger than any potential loses, in order to ensure people are comfortable with the risks they are taking. Therefore, ensuring that people are aware of the potential for loss will help improve decision making.

Nonetheless, amongst investment products with the potential for losses, some products have either a higher likelihood of losses occurring, or the potential for larger losses to occur. Therefore, while the financial promotion rules should flag the potential for loss, it might be helpful to supplement this (possibly at a later stage in the process), with some form of pictorial risk indicator that conveys the level of relative risk associated with each product. Having all providers using the same pictorial risk indicator can significantly improve the ability of consumers to make effective choices and to match products with their risk appetite. It will be important that the methodology used to underpin such pictorial depictions of risk is consistent across products and providers, which allows consumers to make comparisons. The risk indicators must also be designed in a way that will ensure risk rankings remain stable over time, reflecting a product's long run characteristics, rather than simply short run data outturns.

Q10: a. Do you think visual based risk warnings should be introduced for high-risk investments?

b. If yes, what visual based risk warnings should be introduced?

c. Please explain your answer.

We believe, and have argued for some time, that clearer and consistent labelling and information is an obvious pre-requisite to consumers making effective decisions. If the risks cannot be clearly and unambiguously communicated in a direct journey with a fair expectation that the consumer will understand them *and* the likely outcomes of their decision, then the product should be viewed as unsuitable for direct purchase and the consumer guided to other, non-direct, purchase channels. But we do not think that

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[1] Choosing wisely: preferences, comprehension and the effect of risk warnings on financial promotions for investment products Maura Feddersen, Cameron Gilchrist, Lucy Hayes, Timothy L. Mullett, Helena Robertson, Laura Smart Neil Stewart, Jonathan Titley. June 2020

labelling will be sufficient on its own, so it will need to be accompanied by measures to ensure products meet certain standards.

The complexity of investments and investing; the variability of returns; the risk to capital and the suggested longevity of investment; etc, doesn't lend itself to a simplistic 'traffic light' or 'icon based' approach (such as food contents) <u>on its own</u>. This is especially true for consumers either new to, or less confident, about investing. Whilst tools such as these can play a part in informing consumers, the hurdle must remain that the consumer fully understands the investment and the possible outcomes of the decision they are making.

Whilst 'ISA', 'Low Cost', 'Tracker' type flags may be useful to the consumer in their initial screening, we are not convinced a consumer could fully comprehend the choices they are making by such labelling on its own. Labels are by their nature very brief and so over-reliance on them could lead to consumers investing in unsuitable products with less understanding than they have now about risks and potential downsides. As an example of a recent failure of labelling, the recent research paper by Warwick Business School[2] identified that when consumers were comparing choices between higher-risk products, the participants preferred the riskier product (mini-bonds) over the less risky stocks and shares ISA. The team suggested that whilst this may have been a genuine product preference, it may also indicate that mini-bonds, for whatever reason, were wrongly perceived as less risky. This is an area where a robustly applied, comparable labelling system may have helped.

The use of standardised labelling could make it easier for consumers to understand the type of product they are reviewing and its key features in a way that is easy to compare and contrast with other products. This may enable consumers to more easily remain within the product and investment ranges they understand and are more comfortable with, without inadvertently straying into unintended choices. Certain labelling may change some investment products for the better. For example, if there was a mandated traffic light label for *'value for money'* this may lead to providers developing new and existing products to offer better, more competitive value, as those products labelled 'Red' may be harder to sell. However, we see a number of risks associated with this approach:

- The use of RAG ratings can be confusing, with some consumers interpreting red as high return (good) and others interpreting red as high risk (bad). Depending on the context and the information being provided using RAG ratings, this can lead to confusion. Consumer testing of pictorial risk ratings in the UCITs market found that a thermometer running from blue to red performed better and helped consumers make better decisions. It will be important to ensure that any pictorial options, or standardised labels, are properly tested to ensure they lead to effective decision making;
- It will be important to ensure that there is a consistent methodology used to assign a given label or picture to different products, or different options within a given product group. Unless the methodology is applied consistently, it risks leading to consumer harm where products would be rated differently on the basis of different methodologies in use;

[2] Choosing wisely: preferences, comprehension and the effect of risk warnings on financial promotions for investment products Maura Feddersen, Cameron Gilchrist, Lucy Hayes, Timothy L. Mullett, Helena Robertson, Laura Smart Neil Stewart, Jonathan Titley. June 2020

- Consumers may become too reliant on the labelling (which is unlikely to fully convey the risks and features of an investment) and therefore may make decisions without fully understanding their chosen option;
- The use of labels may oversimplify the market and instil a false sense of confidence in consumers;
- Products may be designed that 'hit' and deliver the right labels but suffer elsewhere in their proposition, to the detriment of the consumer; and
- As has been observed recently, scammers may use the labelling to create a halo for their product and mislead consumers into not looking in more detail at the investment.

Q11: a. Do you think additional 'positive frictions' should be introduced to the consumer journey for high-risk investments?

Yes.

b. If yes, what changes should be introduced?

We do not see why there should be any urgency in the purchase of these type of higher risk investments. We would therefore support the implementation of a dual step investment journey, especially for a consumer's first investment (potentially after which the consumer knowledge can be assumed as being 'grandfathered'), giving the time for the consumer to reconsider their actions as observed in some foreign regulatory jurisdictions[3].

We envisage this (initial investment) journey where the consumer goes through the direct purchase, engaging with the relevant information about the investment to develop their understanding of the opportunity, risks, diversification of the investment etc. The second step would need to occur after a minimum 24-hour 'cooling off period', at which time the consumer would again go through the investment journey and at this stage commit/ transfer funds for the investment. Consumers could also have the ability to exit an investment within the first few days and get back their total investment. A 'cooling off' period could be particularly helpful, given the BritainThinks research suggesting that around four in ten self-directed investors are being solely influenced by emotional and social drivers. These steps would go some way to ensuring that:

(1) any promotion is only seen by those consumers with the understanding and financial resources to accept higher investment risk, and

(2) should a consumer unwittingly access the direct investment journey for investments that are unsuitable, appropriate information and delays are put in place to deter them from investing, whilst allowing the intended consumers to proceed.

(3) there is a chance for review and reflection, and the ability to exit if consumers that experience 'buyer's remorse'.

c. Please explain your answer.

We consider that even these steps are not sufficient and would reiterate our view that the firm has a duty of best interest and therefore the burden for compliance and the accountability for the sale remains with the firm. These firms should be required to prove

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[3] The bank said ….. [it] had neglected an internal rule requiring staff to confirm twice that customers aged 70 years or older were in good health and had a good grasp of its products before making any sales. - https://fr.reuters.com/article/us-japan-post-bank-misconduct-elderly-idUSKCN1VY0GL

that the investment was only promoted to eligible consumers, was appropriate for them (without the use of a consumer's self-certification), and that all the appropriate information and warnings were understood by the consumer.

Both 'just in time' guidance and education should be delivered in parallel around the same topics. This would appeal to the widest range of consumers from those who prefer the passive approach of reading, watching and learning to those that prefer a more interactive experience with tools, worksheets and Apps that guide them through choices and let them make a final decision.

The topics covered should include: basics of investing and investments, are you ready to invest, how much to invest, the benefits of diversification and the risks of not doing so, the risks of investing over different timeframes, behavioural ways to deal with losses, the fees and charges of investing, how are your investments protected, what to do when something goes wrong, how to complain etc.

For those consumers less confident with investing, the access to guidance and education may be the primary and final way for them to ensure they understand the product they are about to select - its features, risks and benefits and the protections and possible redress open to them. 'Just in time' guidance and education would additionally provide a degree of friction in the consumer journey, helping not only those who need further information or help but also vulnerable groups e.g. those at risk of financial abuse or fraud. We envisage this guidance and education being provided by either the firm or by a central organisation, such as MaPS or the Investment Association, or both.

MaPS is already reviewing its strategy, including how to help consumers better understand savings and investments, and we would encourage the FCA to continue to work with MaPS on this agenda. Guidance and education can play a vital role in helping consumers make better informed, better considered, decisions, however, it needs to be positioned carefully as part of the journey in a way that helps without overly encouraging or discouraging the consumer or giving a false sense of confidence.

Q12: Please provide any data you have about the potential impact of any changes discussed in chapter 4. For example: the number of consumers, issuers, firms and investments which might be impacted; the potential costs and benefits of any changes and evidence of the potential effectiveness of the changes.

No comment.

Q13: a. Do you think new ongoing monitoring obligations should be introduced for section 21 approvers?

Yes.

b. If yes, what ongoing monitoring obligations should be introduced?

Investors should have a right to expect regular (at least annual) updates about the performance of their investments. Ongoing section 21 approver monitoring obligations should be in place around these communications with investors.

In addition, section 21 approval should be required for any communication with existing investors where they are being asked for additional capital outlay.

c. Please explain your answer, addressing the issues we identify in paragraphs 5.9 to 5.11.

The section 21 approver process exists to try and reduce harm to potential investors and to ensure that investors in high risk investments have the necessary knowledge and financial resources to minimise the impact of potential harms. Simply having invested in one of these products does not make someone an expert. As such, ongoing monitoring by the section 21 approver has the potential to provide important safeguards, to the benefit of investors.

However, although ongoing monitoring would be helpful, thought needs to be given on how to handle any potential conflicts of interest, where the section 21 approver has an ongoing relationship with the issuer. For example, would section 21 approvers be disinclined to withdraw approval, especially if this seemed to cast doubt over their earlier judgement?

Q14: a. Do you think changes should be introduced to the role a section 21 approver in the client categorisation, appropriateness and pre-liminary suitability assessment processes?

Yes.

b. If yes, what changes should be introduced?

We agree with the proposal that a section 21 approver should check any relevant automated processes used to assess if an investor's choice to invest would be appropriate, in order to ensure that that these processes would comply with FCA rules.

We also agree that there should be a requirement for section 21 approvers to continue to check that any automated processes comply with FCA rules on an ongoing basis.

c. Please explain your answer, addressing the issues we identify in paragraph 5.20.

The use of automated processes in the 'Non-Readily Realisable Securities' and 'Peer to Peer' markets clearly have benefits to firms, because they can reduce the costs associated with vetting potential investors. However, where such firms choose to use a section 21 approver, in order to allow them to market to a wider set of retail investors, they are doing so because they themselves are not authorised by the FCA. This means they may not fully understand the rules themselves; they may not understand how IT system changes associated with any automated processes might breach FCA rules; or that FCA rules themselves may have changed. This makes it important to ensure that a section 21 approver will have a role in certifying their processes, and that any such certification is carried out on an ongoing basis.

The Panel has advocated several changes to the certification processes used to identify appropriate investors, in order to reduce potential consumer harm. Given that the Panel considers that existing rules do not work effectively, it will be important to ensure that mechanisms are in place to ensure that the processes used by those seeking investment will adapt as any new rules are introduced.

Q15: Please provide any data you have about the potential impact of any changes discussed in chapter 5. For example: the number of consumers, issuers and investments which might be impacted; the potential costs and benefits of any changes.

No comment.

Q16: Do you have any other comments you would like to make on the topics covered in this Discussion Paper?

We are pleased to see that the FCA is making use of consumer research to inform choices, particularly research based on experimental methods. The use of such methods has the potential to demonstrate not only whether a consumer "likes" a particular option, but also how such an option might impact their decision making. We would therefore strongly encourage the FCA to continue to make use of this type of methodology wherever possible, in order to ensure that the regulatory framework works for consumers.

We would further encourage the FCA to develop a panel with a broad spread of representative consumers with which they can test some firms' financial promotions. The FCA should elicit feedback as to how this panel perceives the promotion, the product, the firm and the potential risks, benefits and opportunities. The FCA could link specific elements of the promotion with each perception. This would give an ongoing test for how promotions are developing and how words, phrases, imagery and labelling impact consumers' choices.

We would like to refer to methodology used in the FCA's Research Note from Warwick Business School that is referenced in this discussion paper (see para 4.29). Amongst other things, the approach tests how the use of different risk labelling options impacts consumers own preferences. Under this approach, in order to infer whether the information is helping consumers to make the right choice, it will be important to also understand their risk appetite, and it is unclear whether this has been done. An alternative approach would be to use vignettes of different investors and then ask participants to identify which of the products they think would best suit the profiled investor vignette. This will help clarify how consumers might use information in making decisions, without the need to understand how their personal risk appetite will influence decisions.

Finally, we note that the researchers were unsure what was driving the preference for mini-bonds, compared to stocks and shares ISAs. One possibility for this might be the use of "bond" in the product description, as bonds typically pay out before equity in the event of firm failure, and therefore may be perceived as less risky, despite other warnings. One way to test this would be to see how an advert for a mini-bond would compare to an advert for an otherwise identical product that simply uses a different naming convention