The Money Charity Response – FCA DP21/1 on Consumer Investment Promotions (July 2021)

The Money Charity is a Financial Capability charity whose vision is to empower people across the UK to build the skills, knowledge, attitudes and behaviours to make the most of their money throughout their lives, helping them achieve their goals and live a happier, more positive life as a result.[1]

We welcome the opportunity to respond to the Financial Conduct Authority's Discussion Paper 21/1 on financial promotion rules for high-risk investments and firms approving financial promotions.

In this response, we set out our Key Points, make some general remarks then answer a selection of the questions posed in the Discussion Paper.

[1] See box on back page.

Key Points

1. We welcome the attention the FCA is giving to this issue and agree that the rules on promotion of high-risk investments and firms approving financial promotions should be tightened.

2. We disagree with the current definitions of “high net worth individual” and “sophisticated investor” and believe these should be dropped in favour of making sure that all investments promoted to retail investors are safe in terms of their basic design.

3. We question the investment philosophy pertaining to so-called “high-risk/high return” investments and their suitability for various classes of investor. We would like to see the FCA affirm an investment philosophy more attuned with prudent investing and objective measures of value.

4. All investments being promoted to retail investors (including those currently categorised as sophisticated and/or high net worth) should be subject to a test based on standard measures of asset quality, including being able to see what the money is invested in and being able to apply the normal rules of asset valuation.

5. Improved investment warnings (including visual warnings) and frictions should be tested for efficacy with the target population, rather than efficacy being assumed. If such warnings and frictions prove ineffective this will add to evidence of the need for a more fundamental reform of the retail investment market.

6. We agree that those approving financial promotions should be required to ensure that the products to which they have attached their names and reputation continue to comply over time with the terms of the original approval.

7. We note that the FCA’s work on a new Consumer Duty is proceeding in parallel with this consultation. In our view, introducing a properly worded Duty of Care/Consumer Duty accompanied by a private right of action would complement the objective of tightening the rules on financial promotions. A Duty of Care would require those approving financial promotions to ensure that the product(s) being promoted are in the interests of the target investor and unlikely to cause the investor harm.

General Remarks

As a Financial Capability charity, we deliver consumer Financial Education in a variety of in-person and virtual school, workplace and community settings. While much of our work focuses on skills such as budgeting, prioritising expenditure, types of credit etc, we do

address long-term saving and investment, particularly in our pension workshops. We also see interest in long-term saving and investment among some participants in our school workshops.

Our overall approach to financial regulation is that regulation should help people behave in financially capable ways. We regard investment promotions that are misleading or dangerous to be contrary to our approach. We are keen to see the FCA continue to reform financial markets in ways that assist consumers make the most beneficial decisions for their financial lives.

In responding to this Discussion Paper, we question three industry assumptions that inform or partly inform current FCA rules. These are the assumptions that (1) consumers should expect a positive correlation between risk and return, expressed in the phrase "high risk/high return investments", (2) it is acceptable to promote potentially dangerous investments to high-net-worth individuals simply because they are rich enough to lose money, and (3) there is a significant number of "sophisticated investors" in the retail market.

The dubious concept of "high risk/high return investments"

DP21/1 (page 16) in our view correctly identifies the issue of "harm caused from consumers investing in high risk, high return illiquid investments that are not suitable for their needs." However, there is a deeper problem with the concept of "high risk/high return investments" than liquidity or suitability per se. The phrase "high risk/high return" contains an assumption that risk and return are necessarily positively correlated. But there is a contradiction inherent in this idea, which is that "high risk" means a greater probability of losing money, i.e. not making any return at all, or possibly a negative return up to 100%. If someone loses their money, there is no return for taking the risk. Warren Buffett[2] uses the analogy of Russian Roulette to challenge the idea of a positive correlation between risk and reward:

> "If someone were to say to me, 'I have here a six-shooter and I have slipped one cartridge into it. Why don't you just spin it and pull it once? If you survive, I will give you $1 million', I would decline – perhaps stating that $1 million is not enough. Then he might offer me $5 million to pull the trigger twice – now that would be a positive correlation between risk and reward!"[3]

Buffet and other investors of the value investing school advise exactly the opposite: that investors should seek to reduce risk while increasing their likelihood of significant positive

[2] Co-leader with Charlie Munger of the investment firm Berkshire Hathaway: https://en.wikipedia.org/wiki/Berkshire_Hathaway

[3] Warren E Buffett, address at Columbia University 1984, reproduced in Benjamin Graham, ed Jason Zweig, *The Intelligent Investor* (2003 edition), page 547.

returns. The two biggest mistakes made by active investors are (a) to overpay, and (b) to take excessive risk. Both mistakes are made on a regular basis by retail investors in investment markets, as the FCA has observed.

How do professional investors deal with high risks? There is a rational approach to high risk, which is via portfolio construction and risk mitigation. This works where there are known probabilities of success and failure, for example in the film industry or venture capital. Investors in both these fields expect most of their individual investments to fail, while the occasional successes generate such high returns that they pay for the whole portfolio. Experience affirms this approach: film and venture capital have non-linear returns, i.e., most profits are earned by a small number of "hits".

The degree of sophistication required to construct such portfolios is beyond most amateur investors and cannot be relied upon by the regulator. Indeed, one of the frequent problems observed (e.g. with London Capital and Finance, crypto, meme stocks, etc) is that people put too much money into a single investment and do not properly mitigate risk. Professionals do not include high risk investments as "part of a portfolio" in a loose sense, but in a measured and structured mix of investments where the probabilities of success and failure are known from data and where stringent quality checks are made on the projects invested in. It is this degree of sophistication which is beyond nearly all amateur investors.

In our view, the FCA should seek to de-normalise the idea that, for ordinary retail investors, taking high risks is the path to achieving high returns. Investments described as high risk/high return are often dangerous and of a type that nobody investing in a prudent way should entertain. We would like to see the FCA affirm an investment philosophy more attuned with risk mitigation and objective measures of value.

The idea that high risk investments can be promoted to high-net-worth investors because they "can afford to lose money"

One of the justifications given for promoting dangerous investments to high-net worth investors is that they "can afford to lose money". This might be true as a fact, but we think it is morally questionable to allow dangerous investments to be promoted to high-net worth investors simply because they are rich enough to lose money. In our view, high net worth investors should have similar protections in relation to investment promotions as lower net worth investors.

The idea that there is a significant number of "sophisticated retail investors" to whom complex and risky products can be sold

We have seen no evidence in our workshops, or in studies of investment markets, of the existence of the "sophisticated retail investor". When we have discussed this mythical

creature with regulated financial advisers, we have been told that retail investors generally have “zero knowledge” of financial markets. This applies to wealthy investors as well as modest investors because most wealthy people have made their money outside the financial markets. They are familiar with their own domains (e.g. professional football) but know little about financial markets in a sophisticated sense.

In our view (as we suggested in our response to the Call for Input on Consumer Investment Markets)[4] the FCA would be better to proceed on the assumption that there are no sophisticated retail investors and frame the rules accordingly. At least, self-certification and coached certification should be stopped and a more objective approach to establishing the skills of investors be adopted. If it turns out to be impractical to test investors in an objective way, the concept of the sophisticated retail investor should be dropped entirely.

Answers to consultation questions

The questions we have answered are those that have a consumer perspective. We have not answered the questions seeking detailed information from financial service providers.

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 are sceptical whether the approach of finely classifying types of investment will achieve the result the FCA seeks. Whenever there are finely defined rules there tend to be ways of getting round the rules and working in grey areas. In our view it would be better to abandon the categories of “high net worth” and “sophisticated retail investor” to whom certain types of high-risk investments can be sold and adopt the approach that all products marketed to the retail consumer should be safe products in terms of their fundamental design.

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.**

[4] https://themoneycharity.org.uk/media/The-Money-Charity-Response-FCA-Consultation-on-Consumer-Investment-Market-Dec-20.pdf

Rather than fine-tuning the rules and potentially creating further opportunities for arbitrage, we think a better approach is to require all products promoted to retail investors (including those currently defined as high net worth and sophisticated) to meet a quality standard and be subject to a Duty of Care.

Part of a quality standard should be being able to answer "yes" to the following two questions: (1) is it possible to see in a true way what the money is invested in? and (2) can the normal rules of asset valuation be applied to the investment? [5] If the answer to either of these questions is "no", the product should not be marketed to the retail consumer (most professionals would steer clear anyway). A safety standard containing such a test would rule out, among other things, most SPACs, which would be a good thing in the light of the highly opaque and speculative nature of these entities.

"Safe" does not mean there is no possibility of losing money. Prices and markets fluctuate, so it will always be possible lose money by overpaying or being caught by a market downturn. Individual investments can also work out badly, for reasons not foreseeable at the time the investment was made. By "safe" we mean that the product is designed in a fundamentally safe way, rather than in a way that is inherently dangerous.

We agree with the Discussion Paper that safety issues sometimes arise in relation to Readily Realisable Securities (RRSs) as well as to the more obviously dangerous types of investments. For example, while many Exchange Traded Funds (ETFs) contain an observable portfolio of securities consistent with the title of the ETF, others may diverge from the label, be based in tax havens, hold large sums in cash or securities not consistent with the label of the ETF[6] or be synthetic in ways obscure to the retail investor. For this reason, we think a more general quality standard approach is best.

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.

We agree with the Discussion Paper that investments that are opaque or speculative are problematic for the retail investor. The test we set out in answer to Question 3 is key: (1) is it possible to see in a true way what the money is invested in? and (2) can the normal

[5] i.e. using things like p/e ratios, cash flow, total assets in the business, realistic forecasts of future growth etc.

[6] For example, labelling an ETF "green" when it contains a high proportion of greenhouse gas producing assets.

rules of asset valuation be applied to the investment? Applying this test can protect consumers from products that have a fundamentally dangerous design, though it cannot completely protect people from the fallibility of human nature, in the sense that someone can still get caught up in a bubble with investments that are fundamentally sound.

The Discussion Paper (paragraph 3.27) raises the question of access to capital for start-up companies. Because it is very difficult to value such investments, we think they are generally not for the retail investor. The safe way for retail investors to provide start-up capital would be by investing in a venture capital firm with an established record: a firm which has shown over time that it knows how to structure portfolios and generate profits. Such a company would likely pass the safety test we have proposed, providing other aspects of its operations meet regulatory requirements.

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.

While many RRSs are reasonably transparent and match “what they say on the tin”, some are not. If the regulator sees an RRS from any source being promoted to the UK public which in the regulator’s view is inherently poorly designed, misleading or dangerous, it should intervene. RRSs should be able to pass a quality test based on transparency and sound principles of asset valuation.

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

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.

We think the exemptions for high net worth and “sophisticated” investors are inappropriate and should be dropped (see our General Remarks). In the case of high net worth investors we do not see the moral argument for selling such investors dangerous products simply because they can afford to lose money. In the case of “sophisticated” retail investors, we do not think that a significant class of such investors exists.

In our view, all products promoted to all retail investors (including those currently characterised as high net worth or sophisticated) should meet a quality standard.

As a practical matter, we doubt there is a way to successfully deliver a test of investor sophistication, given the requirements for objectivity of the test and non-interference by investment promoters in the taking of the test.

If the FCA decides to keep the category of “high net worth” investor, the definition needs to be updated. The income part of the definition (£100k+) should be dropped, as this is not a measure of net worth. The asset part of the definition should be raised to internationally recognised standards, e.g. £1 million+ of investable assets (excluding housing equity and pension scheme assets) for high net worth and £30 million+ for ultra-high net worth.

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.

See our answer to Question 7.

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

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.

Given the research evidence cited by the Discussion Paper and our own experience, we think that protecting retail investors via risk warnings is challenging. However, we support the FCA experimenting with improved risk warnings to see if they are effective and what types of warning might be most effective. In devising these warnings, we think the FCA should try as far as possible to de-normalise the idea that high returns flow from taking high risks. If there is a significant risk of an investor losing all their money, we question whether this is a suitable investment for retail investors.

Additionally, a Duty of Care (Consumer Duty) with a private right of action will assist in improving retail investment promotions. Under a Consumer Duty, before promoting an investment, firms will need to satisfy themselves that the investment being promoted is in the consumer’s interest and unlikely to cause the consumer harm.

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.

If the FCA decides to proceed with a warnings-based approach (visual and/or verbal), we think such warnings should be tested experimentally. The key question for any warning is whether it produces the desired effect among most of the people it is targeted at.

In a previous consultation response[7] we suggested the idea of colour-coded visual warnings in relation to interest rates, so we agree that if the warnings approach is adopted, visual warnings should be tested as part of the mix.

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

b. If yes, what changes should be introduced?

c. Please explain your answer

We agree with the Discussion Paper that additional frictions should be tested for effectiveness, rather than effectiveness being assumed. In our view it is quite likely that additional friction will fail to produce the desired effect, because consumers have become habituated to "clicking through" many types of online friction, for example terms and conditions for Internet services, booking terms, privacy permissions etc. In the online world consumers generally feel that conditions are imposed on them, so there is little point reading conditions in detail. This may well apply to investment warnings too, especially when consumers are being lured by promises of unrealistic returns, which (according to the research cited in the Discussion Paper) they often do not recognise as unrealistic.

Consumers may assume that if an investment is being promoted by a recognised name or a regulated firm, "someone" has pre-checked the quality of the investment, in the same way that, as individual consumers, we are not required to self-check the bacterial count of the ready meals we buy from the supermarket.

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

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

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

[7] https://themoneycharity.org.uk/media/The-Money-Charity-Response-%E2%80%93-FCA-Consultation-on-Overdrafts-%E2%80%93-Mar-19.pdf

We agree there should be a requirement for ongoing monitoring. If a firm has attached its name and reputation to a particular product, it should make sure that this product continues to comply with the terms of the original approval.

Regarding advertised rates of return (Discussion Paper paragraph 5.10) we think care needs to be taken around the advertising of future rates of return unless there is a contractual obligation (like an ISA interest rate) to pay a certain amount over a certain period. This is because the future is unknown. It is easy for such advertising to be misleading. As noted in our General Remarks, where an investment outperforms the market, this is often followed by regression to the mean.

Approvers should monitor the rates of return achieved by the products they have approved. If they find that that the products they have approved fail to achieve advertised rates of returns, they should intervene, either by withdrawing approval or by making sure the promotion is amended to be more realistic. In its supervision, the FCA should ensure this happens.

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

b. If yes, what changes should be introduced?

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

We agree that the processes for assessing investors should be monitored by approvers on an ongoing basis, as suggested in paragraph 5.19. We cannot comment on cost implications, but because of the risks involved in faulty investor identification (for example identifying an investor as “sophisticated” when they are not) we think that compliance should be monitored closely.

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

The main thing from our point of view is to make the overall environment for retail investing safer. This does not mean ruling out all possibility of losing money, but of making sure that all products promoted to retail consumers, including those consumers currently defined as sophisticated and/or high net worth, pass a quality test and are subject to a Duty of Care. Investment promotions should align with sound investment principles such as transparency, proper asset valuation methods, realistic estimates of future returns and risk mitigation.

If this approach is adopted, we think the FCA has a better chance of getting ahead of some of the mis-selling that has proved problematic in the past.

The Money Charity is the UK's Financial Capability charity providing education, information, advice and guidance to all.

We believe that everyone achieves Financial Wellbeing by managing money well. We empower people across the UK to build the skills, knowledge, attitudes and behaviours to make the most of their money throughout their lives, helping them achieve their goals and live a happier, more positive life as a result.

We do this by developing and delivering products and services which provide education, information and advice on money matters for those in the workplace, in our communities, and in education, as well as through influencing and supporting others to promote Financial Capability and Financial Wellbeing through consultancy, policy, research and media work.

We have a 'can-do' attitude, finding solutions to meet the needs of our clients, partners, funders and stakeholders.

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