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Dear Jason

CP12/19* Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes**

This is the Financial Services Consumer Panel's response to CP12/19*** Restrictions on the retail distribution of unregulated collective investment schemes and close substitutes.

Overview

The Panel strongly supports the proposals in CP12/19*** which should go some way towards protecting retail investors from the risks inherent in unregulated collective investment schemes and investments with similar characteristics – referred to in the Paper as 'close substitutes'. We see the proposals as a tangible example of the future FCA approach to product intervention and a welcome indication of the kind of regulatory action consumers can expect from the new regulator.

This action must however be followed by intensive supervisory focus and where necessary, strong enforcement to act as an effective deterrent. We welcome the evidence of more active enforcement documented in Annex 2 of the CP, but invite the FSA to consider whether the average level of fines and other penalties acts fully to remove the incentive for those so minded to engage in swindles and other practices harmful to consumers. Firms' profits on perhaps £2.3 billion of unsuitable retail investment combined with a perceived low detection rate might suggest the need for much larger penalties – or better detection - if the incentive to deceive is to be offset effectively.

As the CP recognises, there is a strong risk of regulatory arbitrage as new "legal" forms develop to circumvent the spirit of the regulatory regime. The inclusion within scope of close substitutes to UCIS schemes should help, but migration across the perimeter is likely to prove a permanent threat. A regular updating of the close substitute list may be required, combined with penalties that deliver effective deterrence.

We fear that the existing proposals will still leave some consumers vulnerable. The wealth of a high net worth investor may belie the individual's understanding of risks and reward, and firms may be less than diligent in acting in the individual's best interests. Moreover, it is often too easy for unscrupulous salespeople to flatter to deceive the unwary into accepting a status of "sophisticated" investor, without the investor appreciating the full ramifications. The very fact that an individual already owns a UCIS product could be interpreted (unreasonably) as an indicator of "sophistication" – thereby effectively removing a level of consumer protection to which the individual is entitled. Related problems may arise in the case of execution-only sales: it is perfectly possible for individuals to be persuaded to buy an unsuitable product on what is technically an execution-only basis.

We are aware that there are requirements imposed on firms through COBS when retail investors elect to be treated as professional clients. Unfortunately, there are still firms determined to ignore the election requirements, and the disclosure regime itself appears not to be having the necessary impact.

We believe this is an area where greater supervisory attention should be targeted. Possible mitigation might be achieved by improvements to the "clear written warning" and separate consent form that self-certified sophisticates must sign. Consideration based on sampled consumer experience could be given to the most effective content and presentation of these warnings, so that they command the client's attention.

We support consumer choice in financial services and we are not calling for the sale of UCIS and close substitutes to be banned altogether. Nevertheless the depressingly familiar sorry tale of mis-selling and misleading promotions evident from the FSA's work in this sector proves beyond doubt that action needs to be taken to protect the interests of consumers as a whole.

We would have liked to have seen more information in the Consultation Paper about the factors taken into account by the FSA when opting for a ban on financial promotions, rather than a ban on sales. The combination of a requirement that all sales be advised (no execution-only) with a ban on promotion to retail investors could approximate the effects of product ban for ordinary consumers. We think the Cost Benefit Analysis should consider this option; more generally, it is FSA recommended best practice to appraise several options within the CBA, rather than a single preference.

There is more to be done too in the area of sector liquidity. The proposed ban on financial promotions of UCIS and close substitutes will almost inevitably lead to greater liquidity problems in what is an already illiquid market and we would like to see the FSA/FCA monitoring this in the months ahead and reacting where it can help.

We are conscious that there will be a large number of consumers who unwittingly now find themselves owning these highly speculative investments and whose opportunities to divest will be limited. We were pleased to see that the FSA has raised this issue within the body of the Consultation Paper and that a telephone helpline is in place. It is important that the messages within Chapter 5 of the Paper do reach affected consumers and we would like the FSA, probably in tandem with the Money Advice Service, to take all possible steps and use all available

communications media to ensure that consumers are alerted to the important issues that have arisen in relation to UCIS, and the options open to investors now.

The Panel's response to the specific questions contained within the Paper, are set out below.

Q1: Do you agree that we should look to impose restrictions on the promotion of non-mainstream pooled investments to ordinary retail investors?

Yes, we agree. The appalling results of the FSA's earlier work on the promotion and sales of UCIS and products with similar characteristics demonstrates a clear need for further restrictions on the promotion of non-mainstream pooled investments to ordinary retail investors. The information contained in the Paper leaves us in no doubt that retail investors have already suffered detriment at the hands of the industry and anything less than the protections proposed would be unacceptable.

Q2: Are there any other investments that should be treated in the same way?

AND

Q3: Are there any investments caught by the non-mainstream pooled investment definition in the draft rules that you believe should not be?

We think the FSA is right to focus on the risk of regulatory arbitrage. The Panel does not have access to detailed research that identifies product profiles for UCIS and similar investments, so we are not in a position to name specific products that should or should not be covered by the proposals.

What is driving the proposals however is the need to provide an effective level of protection for consumers from incompetent advisers and product providers determined to sell products regardless of whether they are suitable to meet particular investment needs, or who are simply unable to identify the 'end user'. Investments which are not mass market retail products, but which are already subject to effective protection measures could in theory be excluded from scope. But it is also important for the FSA to ensure that the proposals are 'future' or 'innovation' proofed. Products designed to circumvent the ban – and the FSA/FCA's more intrusive regulatory approach is key here - cannot be permitted to reach retail investors. At this stage we think the onus should be on the industry to provide evidence that particular products should be excluded.

Q4: Do you agree that we should remove the general ability of firms to promote UCIS under COBS 4.12.1R(4) category 1?

Yes, we support this overall approach.

Q5: Do you agree that firms should still be able to promote replacement UCIS to retail customers where the original product is being replaced or liquidated?

This is a difficult area. Retail customers who have already been sold a UCIS or UCIS-type product are at risk of churning by advisers looking for income. The additional risk that existing retail consumers with an unsuitable investment might simply be sold another unsuitable investment is identified in the Paper – but of

course the product might also be better. On balance we think it must be right for consumers to be presented with all the options open to them when making a decision, so we agree with the proposal to allow the compliant promotion of replacement UCIS to retail investors where the original product is being replaced or liquidated only. We believe there will be a very limited number of cases where this will be appropriate or suitable however and we will expect the FSA to challenge advisers to demonstrate the facts supporting, and rationale behind, any such sale.

Q6: Do you agree that we should remove the ability of firms to promote UCIS under COBS 4.12.1R(4) category 2?

Yes, we support this proposal.

Q7: Do you agree that we should remove the exemption in COBS 4.12.1R(4) category 8?

Yes, we agree this exemption should be removed and that firms should rely instead on the PCIS Order, which incorporates procedures that should be followed by advisers who view a particular client as a sophisticated investor.

Q8: Do you agree that we should limit the ability of firms to promote QIS, securities issued by SPVs and TLPIs in the retail market?

We agree.

Q9: Do you have any comments or suggested improvements for our approach to SPV-issued securities, including structured products?

We support the FSA's proposed approach and have no suggestions for improvement. As we have said, we support consumer choice and would not want to see consumers as a whole denied access to a range of investment products with different features and risk profiles. What is needed is the application of the principle of Treating Customers Fairly and the exercise of common sense by firms marketing non-mainstream products.

The FSA has a well-established approach for dealing with waiver applications, but we would like the regulator to be particularly vigilant when dealing with waiver requests in this area. It will be an important means of 'policing the perimeter' of these products.

Q10: Do you have any comments on the Handbook guidance we propose to add regarding the use of exemptions in the FPO and PCIS Order?

We think the guidance appears helpful and we have no specific comments to make.

Q11: Do you agree that we should require firms to retain a record of the basis on which the promotion of a non-mainstream pooled investment has taken place for each financial promotion?

Given the FSA's experience of firms' inadequate compliance in this area, we think the introduction of specific requirements with specific compliance oversight responsibility, is absolutely essential.

Q12: Should we require confirmation of compliance with the marketing restriction for each promotion?

Yes, we think this is an entirely proportionate approach.

Q13: Do you agree that the CF10 individual is the correct person to confirm compliance?

Yes, we agree.

Q14: Do you have any comments on the Handbook guidance we propose to add regarding the link between promotion and advice?

We support the inclusion of Handbook guidance and have no specific comments.

Q15: Do you agree with our proposed update to the retail investment product definition?

Yes, we think this would be helpful given that the Paper notes there still seems to be confusion amongst some firms about the implications of the RDR rules for the sale of non-mainstream investments.

Q16: Do you have any comments on the impact of our proposals on existing customers and the distributor firms serving them?

We are pleased that the FSA has highlighted the plight of existing customers within the Paper. The comments and advice in Chapter 5 make sense, but we urge the FSA to do everything in its power to ensure that the key messages for retail investors who already own a UCIS or similar product do actually reach them. Without seeming alarmist we think it important that it is made clear to investors, especially those with undiversified portfolios, that there is a real possibility that they have purchased a product that is unsuitable for their needs, and where typical average returns do not compensate for the extra risks involved.

We would like to see the FSA using all possible avenues to communicate effectively with consumers, including broadcast media, working with the Money Advice Service and consumer bodies and requiring firms themselves to contact affected clients, using text/script prescribed by the FSA. We expect the FSA to deal with advisers swiftly and forcefully if there are any instances of pressure being applied, or incentives being offered, to investors to take no action regarding their existing investments. In a sector with such appallingly low standards of compliance – and consequent substantial detriment to consumers – the number of enforcement cases that have been published is low. A basic principle of action to raise standards, especially when there are low detection rates, is to impose high penalties. The industry has no excuse for advising - or otherwise persuading - ordinary retail customers to buy unsuitable products like UCIS. The FSA is not a zero failure regulator, but in this case it should be a zero tolerance regulator.

We urge the FSA to make full use of the information obtained through the Helpline that has been set up and from advisers to support its assessment of the effectiveness of the proposed action and inform its follow-up work. We would also like the FSA to analyse the trends emerging around how all investors respond to the

increasingly moribund market conditions that the ban on financial promotions is likely to cause.

Q17: Do you have any comments on our analysis of non-mainstream pooled investments?

We have no comments on the analysis in the Paper.

Q18: Do you have any further data on the size of the market?

No, the Panel does not have access to any further data in this area.

Q19: Do you have any comments on our overall strategy to deal with the risks to retail customers of investing in UCIS?

We support the FSA's overall strategy for addressing the risks of investing in UCIS. Redress for consumers who have lost money as a result of non-compliant marketing or mis-selling is clearly a priority alongside steps to prevent further detriment. What continues to concern us is that there are some firms in the investment sector who are either completely ignorant of the basic principles of good advice and suitability of products, or are prepared to ignore them in the pursuit of profit. This behaviour tarnishes the reputation of the majority of financial advisers and makes the task of rebuilding consumer confidence in the industry even more difficult. We hope that the FSA will be swift to stamp out unacceptable behaviour forcefully and publicly.

Yours sincerely

Adam Phillips
Chair
Financial Services Consumer Panel