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Consultation by HM Treasury

Regulatory Framework for Approval of Financial Promotions

1. Introduction

We are writing on behalf of the UK Shareholders' Association (UKSA) and the UK Individual Shareholders' Society (ShareSoc), both of whom represent the views of individual investors. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

We suspect that very few consumers, including those who would count themselves among the more sophisticated retail investors, have any awareness of the lack of rigour in the current system and, consequently, the lack of protection it offers. The FCA regularly stresses its desire to ensure that consumers do not suffer unnecessary harm. The FCA is currently consulting on the consumer investments market (Call for Input – The Consumer Investments Market; September 2020). In his forward to the consultation document Sir Christopher Woolard, the Interim Chief Executive, states:

'The overwhelming majority of retail investors are best served by readily understood, well-diversified and low-cost investments which are already available from a range of providers, but many retail investors don't choose these.'

It is hard to understand how the FCA and government can make this sort of statement and, at the same time, acknowledge that the system governing the promotion of financial products by unauthorised firms is set up to allow the very opposite outcome. The current system of allowing *any* authorised firm (regardless of expertise) to mark the promotional homework of *any* unauthorised firm could hardly be better designed to ensure that unsuspecting retail investors become a target for costly products via misleading promotions which often overstate benefits and understate risks and uncertainties.

We find it astonishing that the current situation should ever have been considered appropriate, let alone allowed to persist. Change is long overdue and in this respect we very much welcome this consultation from the Treasury.

We believe that a much more robust and rigorous approach is required to the system of approving financial promotions by unauthorised providers. The implementation of Option 2 is the very least that should be done to address the situation. We have set out our reasons for this view in our response to the consultation questions below. We have also commented on additional checks and monitoring which we believe are necessary to ensure that the system works effectively in future and that it provides the safeguards intended.

2. Consultation Questions: Proposals for Reform

2.1 Do you agree that a gateway should be established enabling the FCA to assess the suitability of a firm before it is permitted to approve the financial promotions of unauthorised persons?

Yes. It is wholly inappropriate that any authorised firm should be able to 'sign-off' any financial promotion put to it by an unauthorised firm for the following reasons:

- An authorised firm may not necessarily have the competence to assess the product or the promotional claims that are being made by the unauthorised firm.
- An authorised firm may not (as the consultation paper makes clear) exercise appropriate due diligence in assessing the promotion even if it has sufficient knowledge of the product being promoted.
- It may be attractive for an authorised firm to take a less-than-rigorous approach to making assessments. Authorised firms can charge for making assessments and this may become an attractive source of extra income for them if they acquire a reputation amongst unauthorised firms for providing a sure, quick and easy route to sign-off with few questions asked. **This has echoes of the situation with the ratings agencies immediately prior to the financial crash of 2007/8** where they were giving Triple A ratings to products that were, in reality, opaque and extremely risky.
- **There appear to be few sanctions against either authorised firms or their unauthorised 'clients' when things go wrong** and investors lose money because they have been misled – except in the most egregious cases.

2.2 What are the risks and benefits of each of the two policy options put forward? Would there be any unintended consequences resulting from implementation?

One clear risk with both of the policy options is that they do not deal adequately with the risk of inappropriate promotions finding their way into the marketplace. We note that London Capital and Finance (LCF), for example, was an authorised firm. Regardless of the proposals being put forward authorised firms such as LCF would still be able to promote products of their own in inappropriate ways.

We also note that the consultation document gives no indication of the number of promotions that authorised firms are being called upon to sign off each year for unauthorised firms. Without this information it is difficult to assess the scale of the issue and the likely costs involved in controlling promotions from unauthorised firms more tightly.

The risks and benefits of each option appear to be:

Option 1

- Provides somewhat tighter control over the approval of promotions from unauthorised firms. We note with some concern that the consultation document states that the process of permitting an authorised firm to carry out approvals **could be linked** to products or services within the firm's area of expertise. We would have thought that this was a fundamental requirement rather than a possible requirement.
- Offers the benefit of being relatively 'light-touch' from a regulatory and administrative perspective. It simply involves withdrawing the current consent that all authorised firms have to approve promotions by unauthorised firms and then requiring those authorised firms that so wish to re-apply for authority to give approvals. While this may be a benefit to the industry (and perhaps the regulator), from the consumer's point of view it is likely to provide weaker control and is, therefore, a disadvantage.
- It is not clear from the proposal what the FCA's involvement would be in assessing the authorised firms and how rigorous the assessment would be of the applicant's competence to approve promotions of specific financial products. No mention is made of either of how the system would be managed and updated over time. What happens, for example, if staff at the authorised firm leave and are not replaced so that so that competence in a particular area is compromised? Other concerns include:
 - Approval of products in new and emerging areas – some of which are referenced in para 5.6 of the consultation document. Who will be the judge that a separate approval is needed for these? Presumably it will be the FCA; but how quickly will it wake up and respond the fact that a new class of approval is required (before investors have lost significant amounts of money)?
 - Clear classification of financial products; if approvals are to be given to sign off on promotions for particular types of product, some products will clearly fall into distinct categories. Others, however, may not and, particularly in the case of some 'hybrid' products, authorised providers may not have the skills and knowledge to assess the product and the promotion in its entirety.

Option 2

- This is a slightly more 'interventionist' approach which makes the approvals process a regulated activity. This fact notwithstanding, many of the concerns mentioned above for Option 1 also apply to Option 2.
- Specific points in relation to Option 2 include:
 - Is there or is there not a significant problem with unauthorised firms getting easy sign-off on promotions which are misleading and/ or inappropriate? The consultation document suggest that there is a problem and on this basis it would be worth making the approvals process a rigorous and regulated activity.
 - There have to be certain concerns about any 'unauthorised' firm. Our perceptions as membership organisations representing private investors (and informed by our contact with firms authorised by the FCA) is that the procedure for achieving authorised status is not hugely costly or onerous. The fact that firms want to put out financial promotions of their own but are not interested in obtaining authorised status themselves suggests that financial promotions in this area require more stringent regulation.

- We accept that a disadvantage might be that greater regulation will restrict the number of authorised firms wanting to become accredited approvers. It is likely that it will increase the workload on the authorised firms with the necessary accreditation which could slow down the approvals process. However, it can equally well be argued that this would be beneficial. A more rigorous approvals process which makes it harder for unauthorised firms to get their promotions approved should provide greater protection for consumers. We see this as the main objective of the new gateway system.

2.3 If the government was to proceed with one of the two policy options, which would be your preference and why?

We strongly prefer Option 2 because it seems more likely to provide greater rigour in the approval process and give the protection that individual investors and savers require. It should make the authorised firms certified under the gateway scheme more conscious of the risks they are taking on by giving approval to the financial promotions of unauthorised firms.

It has to be added that both options appear deficient in terms of the ongoing involvement of the FCA in this area. We have already mentioned that there should be close monitoring of the promotion of innovative and ‘emerging’ financial products, the ways in which they are promoted and the need for the FCA to keep a close watch on the competence of authorised firms to approve these products. We would also like to see:

- Authorised firms which have approval to sign off promotions for unauthorised firms having a requirement to report to the FCA on the approvals that they had given during the year with details of:
 - the client (unauthorised) firm, the nature of the product and its promotion;
 - the outcome of approval process (approved, refused, approved with amendments);
 - an ‘identifier’ or reference number allocated to each application for approval. Against each reference number the approver should be required to keep a file showing all correspondence relating to the request for approval and a brief report stating the work carried out under the approval procedure and why approval was given or refused.
- A spot check carried out each year by the FCA on a meaningful number of approval applications by selecting reference numbers from the reports sent in by the approvers. This would form a quality check to ensure that the approvals process was working properly. It should also pick up any emerging issues with innovative products and their promotion. This process would be similar to the quality review process that the FRC currently carries out on company reports and audits – although in this case it should be far less onerous and time consuming for the regulator.
- The production by the FCA each year of a report summarising its findings and conclusions from the annual submissions from the approvers and its own quality checks on approvals. This report should be submitted to the Treasury and placed in the public domain.

These provisos further strengthen our view that Option 2, making approvals of promotions by unauthorised firms a regulated activity, would be an appropriate course of action.

Finally, we note the comment in paragraph 5.6 of the consultation document that:

“The FCA has observed a growth in investment products which are issued by unauthorised persons, such as mini-bonds, the financial promotions for which are therefore often approved by authorised persons. The increased prevalence of online marketing channels has meant that misleading financial promotions can quickly reach a mass audience. The current low interest rate environment has drawn large numbers of retail investors towards higher risk products in a ‘search for yield’”.

The current low interest rate environment, which looks likely to persist for some time has indeed provided a strong inducement to retail investors, many of whom have little experience of complex or sophisticated financial products, to consider higher risk products in their quest for higher yield. Growing markets invariably attract new suppliers keen to take advantage of the growing demand. It is for this reason mainly that a robust regulatory approach to the issue of financial promotions by unauthorised providers is required.

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours faithfully,

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