House of Commons Treasury Committee

Future of Financial Services Enquiry

JOINT RESPONSE FROM:

United Kingdom Shareholders' Association

&

UK Individual Shareholders Society

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Future of Financial Services

To: House of Commons Treasury Committee

By: Online Upload via Parliament website

Contents

1. Introduction

1. A long history of regulatory failures demonstrates serious deficiencies in the way that financial services are currently regulated.

2. The UK's departure from the EU means that the UK can now set its own financial services rules, untrammelled by the views of 27 other countries.

3. We believe that major changes are required, particularly in the following areas:

    3.1. Making the best outcome for the consumer the prime objective of the regulatory system.

    3.2. Removing the revolving door where senior employees of the regulator move to employment in the financial services sector and related lobbying and consulting firms.

    3.3. Replacing long detailed regulations which can easily be 'gamed' by financial services providers with tough principles that are properly enforced.

4. The body of our response expands upon these recommendations.

5. From a commercial viewpoint we explain how the financial services industry could find a large market in the world outside the EU, USA and China, provided the environment encourages innovation.

2. About UKSA and ShareSoc

6. **UKSA (UK Shareholders' Association)** is the oldest shareholder campaigning organisation in the UK. We are a not-for-profit company that represents and supports shareholders who invest in the stock market.

7. There are many agents and intermediaries active in financial markets. Unlike them, we are an organisation solely representing people who are investing their own money.

8. UKSA was formed to provide private shareholders with a voice, influence and an opportunity to meet like-minded fellow investors. It is structured as a non-profit making company with annual subscriptions. An elected Chairman and Board of Directors (all volunteers and individuals with a wide range of backgrounds and experience) monitor a regional organisation. Each region benefits from oversight by an elected regional Chairman and Committee.

9. We build relations with regulators, politicians and the media to ensure that the voice of individual shareholders is reflected in the development of law, regulation, and other forms of public policy.

10. **ShareSoc (UK Individual Shareholders Society)** is the UK's largest retail shareholder organisation, acting in all areas of the UK stock market, with more than 7,000 members. It is a not-for-profit company.

11. ShareSoc is dedicated to the support of individual investors (private shareholders as opposed to institutional investors). We aim to make and keep investors better informed to improve their investment skills and protect the value of their investments. We won't shirk from tackling companies, the Government or other institutions if we think individual shareholders are not being treated fairly. See www.sharesoc.org

3. Answers to your questions

12. On the Parliament website, the questions are a bulleted list. We have kept the same order, but have numbered the questions and our responses for ease of reference.

1. How can the UK financial services sector take advantage of the UK's new trading environment with the rest of the world?

13. Our members are individual investors with a wide range of professional backgrounds. Our views on this very wide question are as follows.

14. Following departure from the EU, the UK financial services industry will not be able to sell services to EU countries in the manner it did when the UK was an EU member state. Accordingly, unless the UK financial services industry wishes to shrink to serve only the UK domestic market, it needs to organise itself to serve customers who are outside the main regulatory blocs of the EU, the USA and China. However if it gets this right, it will appeal also to customers in those main regulatory blocs.

15. The UK has many competitive strengths to appeal to customers anywhere in the world. In particular:

    15.1. The UK has great political stability, and a reputation for legal probity. That is extremely important for the sale of asset management services and fiduciary services, where individuals entrust service providers to manage their family's wealth for generations to come.

    15.2. The UK has a reputation for innovation, going back for many decades, for example with the creation of the Eurodollar market. Innovation should be accelerated as the UK can change regulations to adapt to innovation far more quickly as a single state than can the EU with its cumbersome decision making processes, or the USA with its regular political gridlock.

2. What changes should be made to the UK's financial services regulations and regulatory framework once the UK is independent of the European Union?

16. We believe that it is more helpful to suggest an approach to all regulatory and tax policy in the future. We have given some illustrations below, without attempting to review existing law in detail to assess whether changes are, or are not, needed.

16.1. Foreign owners of assets managed by the UK financial services sector should never face UK taxation. Before they transferred their wealth to the UK to be managed by UK asset managers and fiduciaries, the owners had no UK tax exposures. Accordingly, using a UK financial services provider should never cause a UK tax exposure to arise.

16.2. UK financial markets will function better without transaction taxes. Outside the EU there is no risk of the UK embracing the type of financial transactions tax that the EU regularly considers, but the UK should go further and eliminate stamp duty and stamp duty reserve tax on all transactions involving companies listed on the stock exchange. If transaction costs incur sales taxes/VAT, these should be removed as well.

16.3. Laws which drive trust business into other legal jurisdictions such as the rule against perpetuities should be revised.

16.4. Any existing regulations, such as the UCITS ones, which generate consumer trust should be kept.

3. What should the Government's financial services priorities be when it negotiates trade agreements with third countries?

17. The priority should be enabling UK based financial services firms to establish in the third country, and also to have the freedom to provide services directly from the UK to customers resident in that third country.

4. Should the UK open its financial services markets to external competition from countries outside of Europe, or should the UK maintain the current regulatory barriers that apply to third countries?

18. The UK should be willing on a reciprocal basis to allow financial services firms in third countries to provide services to UK customers, subject to the following constraints:

18.1. The UK should remain free to specify the disclosures required in all financial promotions by such firms, to ensure that UK customers are aware that they will be dealing with a third country firm with no protection from UK regulators (unless they have established a UK regulated base in the UK).

18.2. This should include mandatory information written by the Government that such firms must supply to potential customers.

19. Subject to these constraints in the interests of transparency, market competition should be allowed.

5. What skills and immigration policy will the UK financial services sector need once the UK has left the European Union?

20. We have no considered view on this question.

6. How can Government policy and the UK regulators facilitate the emergence of FinTech and new competition; develop new areas of growth for the financial services sector; and promote the UK as the best place to incubate new financial technologies and firms?

21. Where FinTech firms find that existing regulations, especially if they provide little to no consumer protection, are becoming an impediment, the Government should be willing to provide limited derogations from its regulations, on a controlled experimental basis, with full disclosure to potential customers. It needs to recognise that some of these experiments will fail, but that is the way to promote innovation.

22. The UK also needs to make it easier for would-be FinTech entrepreneurs and the IT personnel required to migrate to the UK. For example, Greater London within the M25 boundary could be designated as a talent migration zone, with far fewer restrictions on inward migration by young people with demonstrable technology skills, even if they are low earners at present and do not have the academic qualifications for automatic migration to any part of the UK.

7. Through what legislative mechanism should new financial regulations be made?

23. The present system of broad primary legislation combined with statutory instruments which can be revised more easily.

8. What role does Parliament have to play in influencing new financial services regulations?

24. There should be better resourced Parliamentary committees with more effective interrogatory procedures; see below.

9. How should new UK financial regulations be scrutinised?

25. The issue goes well beyond the scrutiny of new UK financial regulations. The deeper issue is how parliamentary committees can better scrutinise witnesses from regulatory agencies or the industry about compliance or non-compliance with existing as well as new proposals about regulation.

26. The current process of scrutiny involves members asking questions of expertly briefed functionaries under tight time constraints and MPs generally do not have the relevant technical expertise to question them effectively. Our experience is that members are often deceived under the current Committee hearings format, and even when they suspect they are being deceived, they lack the resources to investigate further.

27. The secretariats to Parliamentary committees often do excellent work (the reviews of the HBOS failure (April 2013), and the collapse of Carillion (May 2018) spring to mind), but in our experience they are woefully under-resourced.

28. Neither the Parliamentary committees nor the regulators make much use of whistleblowers. Indeed, whistleblowers are often shabbily treated – we have been told of cases where the regulator has told the firm of a whistleblower in a way that could lead to them being identified.

    28.1. Section 348 of the Financial Services and Markets Act 2000, which penalises disclosure of ‘confidential information’ is a further and unduly restrictive impediment to whistleblowers. In one case, a whistleblower had to appeal to the Solicitor General in order to disclose information to a regulator.

29. Freedom of information requests are another way in which members of the public can engage with regulatory interests. However, our experience is that such requests are easily evaded. We were told on one occasion that information could not be released because it would damage public trust in the regulator!

30. Nor is it ever clear from the outside whether a complaint to the regulator has been resolved. A consumer making a complaint wants at least to know that it has been received, is being dealt with, and eventually resolved. The time it takes to reach any sort of conclusion is also ridiculous. This secretive and laborious process is based on the pretext of having to be very careful about saying anything that might be prejudicial to the other party (the Financial Services provider). This sends a message to the miscreants within the industry

that they can get away with anything. It is up to the industry and the firms to look after their own reputations, not the FCA.

31. We would suggest that the scrutiny process can be improved as follows:

    31.1. greater research and technical support for MPs: academic experts or independent industry experts might work (possibly on temporary contracts) to play an active part in hearings, e.g., by setting out information requests, scrutinising material submitted or even questioning senior functionaries at hearings;

    31.2. greater encouragement of, and support for, whistleblowers to come forward and offer evidence under personal immunity; and

    31.3. enhanced expectations of candid disclosure by witnesses to be achieved by a more vigorous prosecution and punishment of witnesses who show contempt of Parliament by misleading MPs.

    31.4. Relax (or remove) section 348 of FSMA so that public interest trumps confidentiality.

    31.5. Revise the Public Interest Disclosure Act so that whistleblowing is less of a difficult and dangerous legal process.

10. What progress has the Government and regulators made in facilitating key financial services equivalence agreements with third countries; and would an alternative mechanism serve the interests of the UK market better?

32. No response.

11. How should financial services regulators be funded?

33. There are trade-offs in how financial services regulation should be funded. The usual model in most countries is by levies on the industry, as opposed to funding regulation by general taxation. Funding by industry levies provides a stronger discipline on the (direct, as opposed to hidden) cost of regulation, but gives the industry more influence over the regulators.

34. But the deeper and much more important issue is whether there is simply too much regulation – and regulation of poor quality too. We discuss this issue below.

12. Should the mandate and statutory objectives of the financial services regulators change to include wider public policy issues?

35. A public interest test should certainly be part of the ‘mission statement’ of regulators. We suggest the following:

    35.1. The primary duty of all regulators should be to ensure that consumers of the services being provided by the regulated sector are being treated fairly.

    35.2. Subject to that, regulators should aim to maximise competition and innovation in the regulated sector, since both of these produce benefits for society as a whole.

13. How important is the independence of regulators and how might this best be protected?

36. Regulators as currently constituted are too close to the industry they ‘regulate’. They are often fearful of judicial review. Regulation is nearly always seen as a stepping-stone to highly paid employment in the industry, in compliance or senior management roles.

37. Regulatory staff tend to consist of a mix of

    37.1. Ex-industry employees, often approaching retirement, with generic skills to operate at the supervisory level. These are equipped with deep knowledge of the industry that they must now regulate, but often they arrive with the culture and prejudices of the poacher, rather than the gamekeeper. Salaries are competitive (to an extent) with industry pay scales.

    37.2. Specialist ex-industry employees. In making use of specialists, the regulator faces the problem of any organisation trying to use specialist skills. If the specialism is no longer required, the specialists are no longer useful. Conversely, when new products are developed by the industry, regulators and firms will compete for specialist skills: regulators are unlikely to compete successfully in the employment market. A classic case was in the lead-up to the GFC when regulators did not understand products like CDO, CDO squared and so on.

37.3. 'Career' regulators. These are employed from the graduate pool and typically spend their career climbing the management ranks of the regulator (with some exceptions), building experience as they move from department to department. They accept that they will in most cases earn less than their ex-industry counterparts; their ‘reward’ is the status accorded by their position in the management hierarchy. The benefit of career regulators is their independence from the industry, the disadvantage is the layers of management that must be created in order for the promotional ‘reward’.

37.4. Temporary management consultants. A large number of regulatory staff are employed on temporary contracts from the large accounting and management consulting firms at cost. The benefit to the regulator is high quality staff at a competitive rate, the benefit to the consultant is regulatory knowledge that can be used to their profit when the staff return. The costs are obvious: close personal ties to regulatory staff mean unconscious capture of the regulator. Further damaging is the emerging ‘regulatory business model’, namely the creation of rules which have no clear public benefit, but which consultants can use as a product to sell to firms.

38. There is also the ‘revolving door’ problem by which individuals switch roles so poachers become gamekeepers and vice versa, especially at the senior level. This is exacerbated by politicians (often failed politicians who have lost their seats) being rewarded with jobs in the financial services industry for their previous loyalty to powerful industry lobbying groups during their Parliamentary career (‘look after us and we will look after you’). The net result is the emergence of an insider elite (aka ‘the Swamp’) who control the system and have more in common with each other than they do with ‘outsiders’ who lack an effective voice.

39. We say more about possible solutions to these problems in the answers below. However, one improvement could be requiring government approval for senior regulators to move into industry, based on some public interest test.

14. How can the balance between lighter touch regulation and prudential safeguards be best secured?

40. In our experience, regulators are always reactive, never proactive, and can rarely or never have a deep enough understanding of financial matters to actively prevent an emerging problem. In a recent example – the collapse of

London Capital & Finance (LCF) – it was revealed that only when the risks previously identified in relation to mini-bonds had materialised did the FCA act.[1]

41. Moreover, there is simply too much overcomplicated and redundant regulation. Examples include:

    41.1. (Prudential) The CAD (Capital Adequacy Directive) regime whose purpose was to protect banks by an internal model to calculate market risk and hence a capital requirement. The regime came into effect in 1998, and was spectacularly unsuccessful in preventing the GFC. Reasons included:

        i. lack of specialist knowledge of the products which led to the crisis,
        ii. the 'regulatory perimeter' problem – firms which could not get CAD permission simply put the products into the banking book.

    41.2. (Prudential) The Basel II (credit) regime whose purpose was to protect banks credit books using a capital model (the 'Basel Advanced Internal Ratings Based' (AIRB) model) calibrated to 1 in 1,000-year probability of collapse. Famously, HBOS implemented this model in early 2008, and collapsed 9 months later. The problem was that the firm failed to incorporate details of a 'bad book' into the model, with the inevitable result.

    41.3. (Prudential) The Solvency II regime for life insurers, which seems almost designed by the industry to mislead shareholders (and policyholders) on the true value of the firms' balance sheets.

    41.4. (Conduct of business) One of the (good) intentions of Mifid was to make costs to the consumer explicit. However, this also made the costs explicit to the financial officers of fund managers, who naturally wanted to reduce these costs to zero, particularly where they had their own in-house analysts. At the same time, the large sell-side investment banks decided they could give their product away for very low cost because they made so much everywhere else, thus contravening the unbundling

[1] "Report of the Independent Investigation into the Financial Conduct Authority's Regulation of London Capital & Finance plc", para 4.1.

intention of Mifid. As a result, it is now very difficult for a private investor to get to see the reports that brokers write about companies.[2]

41.5. (Conduct of business) Another unintended consequence of over-regulation is the explosion of compliance jobs (we heard of one wealth manager who now employs 100 compliance staff). This naturally drives smaller firms out of business, inhibiting competition. Furthermore, the experience of at least one of our members in dealing with firms' compliance departments suggests that they seem to be batting for the very member of the firm's advisory staff who are trying to bend or break the rules. He spent over a year pursuing a pensions complaint in which the compliance staff seemed to see it as their role to confuse and obfuscate endlessly in the hope that the customer would give up and go away. In the end, the case went to the Financial Ombudsman Service who found in the customer's favour and ordered the firm to compensate him to the tune of many tens of thousands of pounds to make good the losses to his pension pot. Far from investigating the case impartially, the compliance team seemed to see their primary duty from the outset as being one of 'damage-limitation' for the firm.

[2] In the case of Mifid II some of the content seems to have been badly thought through from the start. John Kay writing in the Financial Times in January 2018 commented at some length on the weaknesses of the KID . As he points out, the prospective returns required by the KID are little more than a projection of historic returns over the last five years. He notes that: 'In the past, regulators have rightly emphasised to investors that past performance should not be used as a guide to what they can expect in future. Yet it seems that they have not succeeded in persuading themselves of this important truth'. He goes on to mention specifically the example of the Bitcoin XBT Tracker Fund for which the KID told you that over one year a moderate performance would net you a cool 150% return. Discussions with a number of financial services firms indicate that the KID has damaged investor protection in other areas. Most firms have now withdrawn advisory broking services because it is simply too costly and onerous to comply with the requirements for documenting all discussions with private clients which involve any element of advice. Private clients are therefore either 'on their own' with an execution-only service or else they can take the broker's / advisor's discretionary service. For many retail investors this is an expensive option and one which also forces them to cede all control of their portfolio to the broker / advisor.

It is easy to argue that the weaknesses of Mifid II are a prime example of the very regulation that the UK will seek to avoid having left the EU. However, the UK has form with this type of argument. The FCA amongst others had plenty of input to the development and drafting of Mifid II. Despite this, it seems to have done little or nothing to point out and resist some fairly obvious inconsistencies and flaws which quickly became apparent when Mifid II was revealed to investors. Elsewhere, the UK has consistently 'gold-plated' EU directives when transposing them into UK law. When the constraints caused by this 'over-enthusiastic' interpretation become clear it has always been convenient for the UK government to blame the EU for imposing complex, restrictive and unnecessary legislation.

42. We suggest that, rather than trying to balance 'light touch' with prudence, future legislation aims at protecting underlying principles through the legal process, including more liability of key decision makers and stringent punishment of those who transgress basic principles. Placing reliance on regulatory imposed models inevitably leads to management escaping blame.

43. The culture of regulation also needs to be addressed, so that regulators actually use the powers that they are trusted with. Note that a recent article[3] reported that "As for the watchdog's own record of throwing the legal book at offenders, a recent Freedom of Information request summarises its lacklustre record. In 2018, the FCA disclosed[4] it received almost 7,000 fraud complaints. Yet it opened just 40 investigations in the last two years, and none resulted in a prosecution, let alone a conviction".

15. How should consumer interests be taken into account when considering potential regulatory changes?

44. A key requirement of all regulation should be to ensure that consumers are treated fairly. The current regulatory regime falls short in this respect. Providers of financial services have a natural advantage over consumers due to their much better understanding of the products and services they are providing – often known as 'asymmetry of information'. This is true in any buyer/ supplier relationship and invariably places the buyer at a disadvantage. It is at its most pernicious when buyers fail to understand (or underestimate) the extent which they are not playing on 'level playing field'. This is an issue that current regulation needs to address more comprehensively.

45. We would also like to draw the Committee's attention to the recent Call For Input[5](CFI) by the FCA into the Consumer Investments Market, and to our response to the CFI6, which makes clear that while there exist "readily understood, well-diversified and low-cost investments", most people do not use

[3] "Boom time for investment fraud in Britain", Jonathan Ford, Financial Times, 7 February 2021, https://www.ft.com/content/369ea89d-5871-4e58-b008-820e85d4428f

[4] https://www.fca.org.uk/news/press-releases/fca-warns-public-investment-scams-over-197-million-reported-losses-2018

[5] Call For Input: The Consumer Investments Market (fca.org.uk)

[6] https://www.uksa.org.uk/news/2021/01/30/our-response-fca-consumers-need-work-together-because-fcas-plans-do-not-put

them. This is a well known problem and not enough action has been done. The FCA, in its 2016 Study7, found that:

> *there is limited price competition for actively managed funds, meaning that investors often pay high charges. On average, these costs are not justified by higher returns.*

Putting this another way, those people who know how to avoid high charges, other things being equal, will have massively better pension outcomes than those who do not.

46. The same FCA report also highlighted the issue of closet indexing funds, which charge high fees and are not very active. This is a well known problem and not enough action has been done. This could be addressed by making an appointment to the Committee of someone who is very knowledgeable about individual investors and the issues they face.

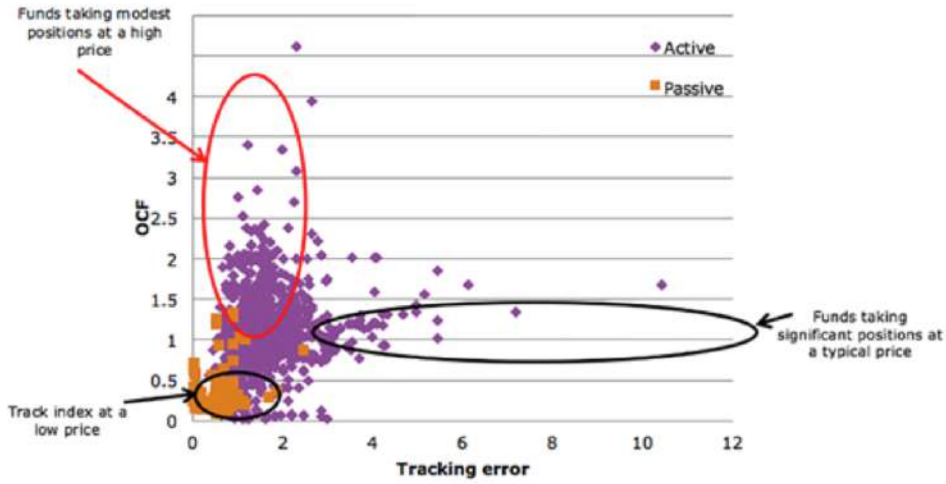
[7] https://www.fca.org.uk/news/press-releases/fca-finds-weak-price-competition-some-areas-asset-management-sector

https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

MS15/2.2 **Asset Management Market Study – Interim Report**

1.27 Many active funds offer similar exposure to passive funds, but some charge significantly more. Figure 1.8 shows the charges (the Ongoing Charges Figure) for active equity funds compared against the 'tracking error'. The tracking error shows the variation of the difference in the returns of the fund against the underlying benchmark. A low tracking error generally indicates that the fund is closely replicating the benchmark, although it may be seeking a small outperformance against this or trying to limit underperformance. There is around £109bn in expensive funds that closely mirror the performance of the market (they have a tracking error below 1.5) and are considerably more expensive than passive funds.

Figure 1.8: Tracking error against OCF for clean equity share classes over 2013-15



Source: Returns and benchmark data provided by Morningstar Direct. OCF data from a sample of asset managers, enriched with information on charges from Morningstar Direct.

47. Mindful of the imbalance of power between the savings part of the financial sector and its customers, the UK Shareholders Association has started a project called Savers Take Control[8]. The goal is that knowledgeable savers and investors, who are independent of the financial sector, should voluntarily share knowledge in the public interest. This, we believe, would be an effective way of helping to protect consumer interests, rather than relying on regulation which itself has inherent limitations in its ability to protect consumers. Accordingly, we request that the FCA support this initiative by acknowledging

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[8] https://www.uksa.org.uk/Savers_Take_Control

the role it could play. As a first step, we suggest the FCA meet with STC representatives.

48. The final point we would like to make in regard to the consumers' perspective of the financial sector is to question the typical approach to the use of experts. In an area such as the financial sector, those people with the necessary understanding will almost always either be working directly in the financial sector, or will be dependent on it in some way. How deep is the reservoir of knowledgeable people who will really be speaking from the consumer perspective? This reservoir is dwarfed by the paid lobby of the financial sector. There are a number of suitable and highly respected individuals who Parliament make considerable use of – an example would be Professor John Kay. But we would suggest that one place from which suitable unbiased advice could be sought is people who have retired from the financial sector, and who now would be prepared to "give back" to society in the interests of consumers and future generations. We believe that there are many such people. Parliament might bear this observation in mind when considering the constitution and governance within the future regulatory framework.

16. What are the strengths and weaknesses of the European Union model of scrutinising financial services legislation?

49. No response.

17. Should the UK seek to replicate the EU's model for drafting and scrutinising financial services regulation?

50. No response.