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

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9 March 2022

By email: FinProms@hmtreasury.gov.uk

Dear Sir / Madam,

Financial Services Consumer Panel response to HMT consultation on Financial Promotion exemptions for high net worth individuals and sophisticated investors

The Financial Services Consumer Panel (the Panel) is an independent statutory body. We represent the interests of individual and small business consumers in the development of financial services policy and regulation in the UK.

We welcome the opportunity to respond to this consultation to improve the regulation of financial promotion exemptions for high net worth individuals and sophisticated investors.

We consider it important that the overarching regulatory regime governing retail investments, including financial promotion rules, provides a coherent approach to setting regulation that meets consumers' needs. 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;
- the use of client self-certification must cease;
- 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;
- 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 Panel considers that the current definitions used to define a high net worth individual and the use of self-certification to determine if an investor is sophisticated will not provide adequate protection. There is also considerable evidence that too many investors are self-certifying as meeting the criteria, when they do not. This means that the current rules are likely to result in investment by consumers who either do not understand the risks, or cannot afford to undertake the risks. Self-certification is harmful not only to the individual who wrongly certifies themselves, but also to firms and the wider industry, because of reputational damage.

The Panel therefore welcomes the Government's decision to seek to reform financial promotions exemptions. The Panel particularly welcomes putting greater responsibility on firms to assess if investors truly meet the criteria, as well as proposals to tighten the relevant definitions.

However, the Panel remains concerned that the proposals being considered do not fully address potential harms. In particular, we are concerned about the exemptions in the Financial Promotions regime relating to self-certification, which in our view significantly weaken the regime's ability to protect consumers. The Panel would therefore like:

- self-certification to cease;
- if self-certification is retained, the terminology should be changed to use more neutral descriptions, such as "highly experienced" rather than "sophisticated"; firms must also be required to prove that they carried out suitable due diligence on an individual's claim that they are eligible
- an automatic indexation mechanism for thresholds, such as those associated with the definition of high net worth investors, to be introduced in order to ensure that thresholds do not become misaligned in future; and
- changes to investor statements to be tested with consumers before final changes are introduced, with testing focused on whether the changes will deliver improvements in decision making, rather than simply whether they are liked.

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

Yours sincerely,

Wanda Goldwag

Chair, Financial Services Consumer Panel

Annex A – responses to questions

1. Do you agree that the exemptions should be retained?

No. The Panel is particularly concerned about the use of self-certification and considers that this should cease.

FCA research[1] shows that roughly twice as many individuals certified themselves as sophisticated or high net worth investors than met the criteria - 33% of the sample self-certified, compared to 16% that met the objective definition. This suggests that self-certification will continue to create problems in the market, even with the changes proposed in both this consultation and the FCA's consultation CP22/2.

2. Do you agree with the objectives for reform? Are there other objectives the government should consider?

The Panel broadly supports the three objectives set out in this consultation, namely that:

1. Thresholds for exempt investors are calibrated to reflect investors' experience or their ability to absorb losses;
2. There is a reduced risk that investors receiving financial promotions under the exemptions do not meet the relevant conditions;
3. Investors understand the regulatory protections they are losing when exemptions are used, and are able to take responsibility for their investment decisions.

In the case of the second objective, the Panel considers that the aim should be to significantly reduce the risk, particularly in light of the problems with self-certification.

In addition, the Panel considers that a fourth objective should be added, which is to ensure that only appropriate types of investment are able to use any exemptions. Thought should be given as to whether there are any additional aspects to the current legal framework that might prevent the FCA from achieving this goal, particularly in light of a rapidly changing investment landscape.

3. Do you agree that the financial thresholds for high net worth individuals should be increased? At what value do you think the thresholds should be set? Please justify your answer.

Yes, the Panel strongly supports increasing the financial thresholds for high net worth individuals, but considers that simply increasing the thresholds in line with price inflation will not be sufficient, particularly in light of international comparisons. In addition, the Panel believes that consideration should be given to introducing an automatic indexation mechanism, in order to ensure that the thresholds do not become misaligned in future.

As set out in the consultation, the value of the thresholds used in the current definition of high net worth individuals[1][1] have been significantly eroded since the financial promotion exemptions were originally introduced. To put the reduction in the effectiveness of the thresholds in context, the Panel notes that:

- average house prices in the UK were £83,976 in Q1 2001, or roughly a third of the net assets threshold when it was introduced. However, by 2021 Q4 average

[1] https://www.fca.org.uk/publication/consultation/cp22-2.pdf - paragraph 4.44

[1][1] Namely someone who has earned at least £100,000 in the previous year, or has net assets (excluding their primary residence or pension assets) of at least £250,000.

UK house prices had risen to £253,113, or more than the £250k net asset threshold, a threefold increase;[2][2] and

- over the period between January 2001 and December 2021, average weekly whole economy pay increased by 84%, compared to the 54% increase in consumer prices noted in the consultation.[3][3]

The Panel would prefer the income threshold to increase in line with wages rather than prices. This is because consumer price indices do not capture all costs (for example housing costs are typically excluded). While not perfect, using wage increases will help guard against the impact of these omissions.

The Panel would prefer the net asset threshold to increase in line with asset prices, rather than consumer price inflation. This will help ensure that the thresholds will more accurately reflect whether an individual is truly high net worth.

Beyond uprating the thresholds in line with the appropriate asset price or wage indices on an ongoing basis, the Panel considers that it would potentially be helpful to align the thresholds to the existing definition of high net worth individuals in the mortgage market, which are significantly more stringent. 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." Aligning the two definitions to the more stringent definition would not only improve the protections associated with this exemption, it would also reduce confusion amongst consumers as to whether they meet the definition or not.

4. If you are a business (or trade body who represents businesses) who use the exemptions when promoting investments to investors, can you provide information on the investor profile of the investors who are promoted to within the exemptions? How would increasing the high net worth investor thresholds affect your ability to make communications to these investors?

No comment.

5. Do you agree that the assets in scope of the net asset calculation should remain the same?

Yes the Panel agrees that the definition of net assets should remain the same. In other words, it should exclude: an investor's primary residence, or any loan secured on that residence; any rights under a qualifying contract of insurance; and any benefits in the form of pensions or otherwise which are payable on termination of service or on death or retirement to which the individual in question or their dependents are or may be entitled.

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[2][2] Based on the Nationwide UK House Price Index (https://www.nationwidehousepriceindex.co.uk/resources/f/uk-data-series).

[3][3] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearningsearn01

6. Do you agree that the unlisted company criteria of the self-certified sophisticated investor test is no longer a reliable way of demonstrating sophistication, and therefore should be removed?

Yes.

The Panel is against self-certification and therefore considers that any tightening of the existing thresholds to make it harder will be helpful.

In the case of the unlisted company criteria under the existing rules, the Panel also notes that the current wording is ambiguous, as it could apply to multiple investments in the same firm. This would be a less robust threshold than one that involved investments in a portfolio of several unlisted companies.

7. Do you have suggestions for other tests that could be included to demonstrate sophistication, and could be incorporated into the definition of a self-certified sophisticated investor?

Financial promotion exemptions can be used across a range of high risk investment activities, not purely those associated with financing unlisted companies. As such, it would be helpful to ensure the definitions used for those self-certifying ensure that they have had exposure to a broad range of financial assets and products, as this will help ensure they are better able to weigh the potential costs and benefits. Consideration should therefore be given to developing a criteria that will capture this breadth of exposure (for example the need to have invested in x% of y options), as well as how active they are as investors.

8. Do you agree that the fourth criteria of the self-certified sophisticated investor definition should be updated so that the company must have, or have had, a turnover of at least £1.4 million?

The Panel opposes the use of a criteria based on being a director of a company as part of the self-certification process, regardless of the turnover of that company. An HR director, for example, might meet this definition, without ever having had responsibility for assessing or deciding on investment options, or preparing financial statements as part of their role.

Note, the same issue would exist for an HR professional working in a private equity firm.

9. Do you agree that a greater responsibility should be placed on firms to ensure that prospective investors satisfy the thresholds for categorisation as high net worth individuals or self-certified sophisticated investors?

Yes.

10. If so, do you agree that the emphasis of the "reasonable belief" be shifted so that the firm communicating the financial promotion must have a reasonable belief that an individual meets the criteria?

Yes.

Additionally, the Panel considers that it would be helpful to ensure that this responsibility included a responsibility to check external sources (such as credit reference agencies), in order to verify that the thresholds are reached.

11. Do you think there is a better alternative than placing greater responsibility on firms to ensure that prospective investors satisfy the thresholds for categorisation as high net worth individuals or self-certified sophisticated?

While the Panel supports the proposal that firms should have greater responsibility for ensuring that potential investors meet the necessary thresholds, it remains concerned about the use of self-certification and considers that this should cease.

12. If you are a firm who uses the exemptions, how would you establish a reasonable belief that a particular individual satisfied the relevant net worth or sophistication criteria? How would this compare to what you do now? If you envisage problems in establishing whether a consumer meets these criteria please explain why?

No comment.

13. Do you agree that firms should be required to provide details about themselves in any communications made using the exemptions?

Yes.

14. Do you agree that the investor statement should be updated to achieve greater engagement from investors and awareness of the regulatory protections they are losing in receiving financial promotions under the exemptions?

Yes.

It is well understood that consumers have limited understanding of the protections available to them. For example, FCA research[2] shows that 57% of those investing in foreign exchange and 69% of those investing in cryptoassets incorrectly believed that these are regulated by the FCA.

This makes it important that changes should be made that help address this issue. The Panel considers that it will be important for potential changes to investor statements to be tested with consumers before final changes are introduced. Such testing should be focused on whether the changes deliver improvements in decision making (ie behavioural testing), rather than simply whether they are liked.

15. Do you agree with the proposed changes to the investor statements?

Yes.

The Panel supports changes that will simplify the language used, require greater investor engagement and ensure that the criteria defining high net worth and sophisticated investors are properly understood.

The Panel considers that the exact nature of any changes should be an empirical matter and that it will be important that potential changes to investor statements should be tested with consumers before final changes are agreed. Such testing should be focused on whether the changes deliver improvements in decision making (ie behavioural testing), rather than simply whether they are liked.

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[2] https://www.fca.org.uk/publication/consultation/cp22-2.pdf - paragraph 4.8

16. Do you have any other suggestions for how the investor statement could be updated to ensure greater investor engagement, for example, to work more effectively as part of a digital journey?

No comment.

17. If you are a firm that uses the exemptions, do you envisage any issues with the proposed changes, particularly to require individuals to set out how they meet the exemption criteria? Please justify your answer.

No comment.

18. Do you agree that the title of the 'certified high net worth individual' exemption should be updated to 'high net worth individual'?

The Panel agrees that removing the term "certified" from the description of "high net worth individuals" is appropriate, given that there has been no requirement for external certification to take place since 2005.

However, the Panel considers that, as an alternative, consideration should be given to using the description "verified high net worth individual". This would emphasize to both firms and individuals that verification is needed to ensure that individuals meet the necessary criteria. This could have potentially beneficial behavioural impacts, such as reducing the likelihood that individuals will exaggerate their financial circumstances, given the potential that they could be found out.

19. Are there any other ideas that you feel would deliver on the three objectives of these proposals, outlined in paragraph 4.7.

The Panel considers that consideration should be given to changing the name of the classifications of "sophisticated investors" and "self-certified sophisticated investors". For example, using the description "highly experienced investors" and "self-certified highly experienced investors" would create different incentives.

The Panel continues to be concerned about the use of self-certification and ideally considers that self-certification should cease. However, should it be retained, the Panel is particularly concerned in connection with the term "sophisticated". Most people aspire to be sophisticated, and whether someone sees themselves as sophisticated is inherently subjective. This creates perverse incentives, because people may be more likely to classify themselves as sophisticated, even if they are not in the technical sense associated with financial promotions, because they aspire to be labelled sophisticated.

The mismatch between reality and self-certification is borne out in the behavioural research underpinning the proposals contained in the FCA's consultation on high risk investments (CP22/2, see para 4.44 on p29). Even with the additional changes proposed by the FCA, tests showed that roughly twice as many individuals certified themselves as sophisticated or high net worth investors than met the criteria - 33% of the sample self-certified, compared to 16% that met the objective definition.

20. The financial promotions regime plays an important role in protecting vulnerable consumers when investing. The government would welcome views from groups that represent vulnerable groups regarding any of the information presented in this consultation, and in particular on the proposals outlined in the preceding chapter.

The Panel is a statutory body that represent the interests of individual and small business consumers in the development of financial services policy and regulation in the

UK. The Panel has four suggestions in relation to the functioning of the financial promotion exemptions regime:

1. As previously stated, the Panel is concerned about the use of self-certification and ideally considers that self-certification should cease. There is considerable evidence that too many investors are self-certifying as meeting the criteria, when they do not. Given that the rules have been put in place in order to protect potential investors from harm, this is undesirable. Therefore the burden should be on firms to ensure that potential investors meet the necessary criteria.
2. Although the Panel would prefer to see self-certification removed, if self-certification is retained, the Panel considers that it would be helpful to move to more neutral descriptions, such as "highly experienced" rather than "sophisticated". This would potential reduce the behavioural biases that lead people to incorrectly self-certify.
3. The Panel considers that as part of the reforms it would be helpful to introduce an automatic indexation mechanism for thresholds, such as those associated with high-net-worth investors, in order to ensure that thresholds do not become misaligned in future.
4. The Panel considers that it is important that the route to market should not determine the protections that are available, as this potentially creates confusion. Therefore, where offerings are available through more than one channel, all investors should be able to access the most stringent protections, whether they qualify for exemptions or not.

21. If you are a firm or individual who relies on the OPE to provide or receive financial services from foreign jurisdictions, what effect would the proposed changes have?

No comment.