HMT Treasury's Consultation on Financial Promotions

Submission by the Transparency Task Force:

October 25th 2020

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About the Transparency Task Force

The mission of the Transparency Task Force is to promote ongoing reform of the financial sector, so that it serves society better. Our vision is to build a large, influential and highly respected international institution that helps to ensure consumers are treated fairly by the financial sector. The primary beneficiaries of our work will be consumers; but the sector itself will also benefit through improved market conduct and increased trust in the services it provides.

Our objective is to carry out a broad range of activities that help to drive positive, progressive and purposeful finance reform, such as:

- Building a collaborative, campaigning community; the larger it is the more influence it can have in driving the change that is needed
- Raising awareness of issues; so that society better understands the problems that exist in the financial sector and how they can be dealt with
- Engaging with people who can make change happen; because through such dialogue we can influence thinking, policy making and market conduct

Much of our focus is on rebuilding trustworthiness and confidence in financial services. To make this possible we are busy developing a framework for finance reform which we describe as a “whole system solution for a whole-system problem” as described in our recently published book

For further information about the Transparency Task Force see:
http://www.transparencytaskforce.org

Introduction

This document has been produced by a group of Transparency Task Force volunteers working collaboratively to help improve the effectiveness of the UK's Financial Services regulatory framework. Our motivation is to improve consumer protections, consumer outcomes and market efficiency.

Our input is not meant as a detailed "instruction manual" on what needs fixing and how to go about it. Rather, it sets out what we believe to be the key discussion points that warrant further investigation. We therefore hope our input will help to initiate dialogue amongst all relevant stakeholders including of course scam victims and the many campaign organisations that represent their interests.

As you will read, we are constructively critical of the present situation. We believe there is a woeful lack of proactivity by the regulators in closing down scam and misleading advertising. We passionately believe that the best way to tackle poor conduct is to prevent it happening in the first place - it's obviously much better than clearing up the carnage after the event. "Prevention is better than cure" remains a wise approach to problem solving.

We have used the current situation with German Property Group "GPG" (formerly Dolphin Trust) to highlight some of the issues we believe are inadequately dealt with the current regulatory framework.

We hope that HM Treasury and all relevant regulatory entities can adopt a "progress begins with realism" mindset i.e. a willingness to absorb and make good use of constructive criticism as a basis for making improvements. We make this point as we believe that Regulators sometimes seem rather defensive and unwilling to accept their shortcomings. Our constructive criticism is well-intended; and we hope that it might be valued for what it is - a blend of creative input and honest feedback.

More than just a written response

We are pleased to provide access to the video recording of the symposium we ran about your consultation, on Wednesday, October 14th. It is an integral part of our consultation response to you. The event details are here and the video recording itself can be watched here.

We are very grateful to HM Treasury's Madalena Leao for attending the symposium.

Our approach to responding to your consultation

We feel the questions you have posed in your consultation, namely:

> *#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?;*
>
> *#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?; and*
>
> *#3 If the government was to proceed with one of the two policy options, which would be your preference and why?*

...are unhelpfully narrow i.e. by just responding to those specific questions HM Treasury would miss the opportunity to receive what we believe to be the worthwhile additional input we can provide.

We have therefore decided to provide our written response in 2 parts:

> Part 1: Our general observations and suggestions.
>
> Part 2: Our response to the specific consultation questions.

Part 1: Our general observations and suggestions

Protecting the public from scams and not-as-advertised financial products

A robustly policed and enforced Financial Promotions Regime (FPR) would provide an efficient and effective gateway control to prevent scams. Action after the event is also needed to create a credible deterrent but by then consumer harm has been done; prevention is better than cure.

Furthermore, it isn't just outright scamming that needs to be tackled. It is vital that consumers are also protected from financial promotions that do not authentically describe the reality of the products they are promoting. One of many examples would be the financial promotion surrounding the Woodford saga; it is crystal clear that investors were buying into an investment fund that was not as described, with extensive consumer detriment as a direct result.

However, fundamental flaws with the current FPR and its enforcement have left the gateway open to those that mislead, intentionally or otherwise as well as fraudsters. The key is to ensure that Promotions clearly and straight-forwardly set out the investment proposition, the deal structure and relevant risk factors of the investment that they describe.

These flaws are a major factor behind the current epidemic of consumer harms impacting savings, investment and pension funds. Some cases are small; others very large indeed.

An example of the latter would be the case of GPG; an unregulated product that has been marketed to UK investors - at least 50% who invested via pension monies and others who invested lump sums derived from pension monies. It was "signed off" by a regulated IFA, Blackstar Wealth Management, which has subsequently gone into liquidation. It was marketed widely by both regulated and unregulated firms, driven by commissions of up to 20%. The net result being that the company in Germany has entered into a liquidation process which could take up 7 years or more to resolve. There is no certainty of the outcome; investors may even get nothing back at all, in which case, some £300m will have been lost by UK investors alone, possibly in excess of £1 billion altogether worldwide.

Regulatory Background

The current Financial Promotions Regime requires financial promotions issued by unauthorised firms to be approved by a Financial Conduct Authority authorised firm subject to a number of exemptions.

Financial promotions are restricted under Section 21 of the Financial Services and Markets Act 2000, pursuant to which a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity unless the promotion has been made or approved by an authorised person or it is exempt. Unauthorised firms often use authorised firms which are authorised to carry on a regulated financial services activity to approve their Promotions in order to comply with the Act and the regulations under it.

Although authorised firms are required to keep a register of promotions that they approve, the FCA does not meaningfully supervise this activity. Without meaningful supervision and enforcement the present regime does not protect investors, enabling unscrupulous promoters of investment products and services to take advantage of consumers.

Authorised firms are not required to notify the FCA once they have approved an unauthorised firm's Promotion, nor does the FCA sign off on approved Promotions before they are communicated to consumers. As such, the FCA is only made aware of potential breaches of the relevant regulations.

1. Issues with the existing Financial Promotions Regime

Regulation Issues:

I. There is no specific permission FCA authorised firms are required to have before they can approve a financial promotion.
II. There are no qualification or competency requirements for firms approving financial promotions.
III. There is no requirement to register or process for registering investments for which financial promotions have been approved. Hence neither the FCA nor consumers have access to records of investments where the promotions have been approved.
IV. Authorised firms and unauthorised firms with a FCA authorised group company are able to issue financial promotions without independent approval is a significant cause of consumer harm. Examples being London Capital & Finance , Basset & Gold and now GPG.
V. There is no clear set of requirements that an approving firm is required to apply to the approval exercise. For example there is no clear requirement that a Promotion must clearly and straight-forwardly set out the investment proposition, the deal structure and relevant risk factors taking into account the intended target audience.

Transparency issues:

I. Consumers cannot establish whether a promotion genuinely has been approved.

II. Consumers cannot establish whether approval of a financial promotion has since been withdrawn. This is a particular problem in practice with investment scams and frauds whereby a rogue FCA authorised firm approves a promotion then immediately withdraws approval.
III. Consumers often believe that approval of an information memorandum for an investment by a FCA authorised firm means that the investment itself is regulated by the FCA. Sometimes the firm may be regulated but the product might not be; there have also been instances of products that have been regulated but the FCA has *ex post* claimed otherwise. Connaught is an example of the former, LCF the latter.
IV. There is no reliable way for consumers to establish whether a firm offering its own securities is carrying out a regulated activity. Scammers thrive on this
V. There is no reliable, independent or efficient means for publishers of adverts (including online platforms) which are financial promotions to verify whether a promotion has been genuinely approved by an FCA authorised firm.
VI. There is no reliable, independent or efficient means for pension trustees, ISA managers, banks, building societies to verify whether a product subject to a client transfer has been lawfully promoted.
VII. There is no reliable way for consumers to establish whether or not the claims made in the promotion are valid, consistent and reasonable. Promoters may, for example, make unreasonable and/or inconsistent claims regarding return expectations.
VIII. There is no independent risk assessment of the promoted product/service to enable a consumer to assess the risk of the product/service either in isolation or within a portfolio context.
IX. There is no standardised framework/benchmark for measurement of the promoted product/service risk/return attributes.
X. There is no requirement for any cited risk, return, nor other characteristic to be clearly contextualised, to enable the consumer to evaluate the conditions and assumptions under which the characteristic expectations were formed. For example, expectations cited by the promotion may only be valid under a particular set of restrictive conditions.

Exemption Issues:

i. Online platforms operating from EEA states outside of the UK which qualify as providers of an *information society service*s such as Google Ads and Facebook are currently exempt from UK regulations relating to financial promotions. As a result of the exemption contained in Article 20B of the FPOthe online advertising platforms are not liable for the content to the adverts they charge to publish and so take no responsibility or effective action to vet advertisers and adverts. This issue is evidenced by the following from a 31 Jan 2020 email from FCA Chief Executive Andrew Bailey to Mark Taber:

> *Our analysis is that search results generated by Google and, in particular, paid adverts may constitute financial promotions. Google is likely to be 'communicating' such financial promotions for the purposes of the restriction in section 21 of FSMA. Google is not authorised by the FCA. So any financial promotions communicated by Google must be approved for the purposes of section 21 unless one or more exemptions in the FPO apply to their communication. On the basis that it provides an information society service, for the purposes of the EU E-Commerce Directive, from an EEA state outside the UK, it appears to us that Google generally benefits from the exemption in Article 20B of the FPO for incoming electronic commerce communications.*

ii. Unauthorised firms are able to issue unapproved financial promotions to consumers classified as HNW / Sophisticated. This exemption is being abused beyond belief by unregulated introducers and the boiler rooms they work with. They hide it in the small print, make the sale verbally then get a signature at the last-minute glossing over it as an inconsequential bit of paperwork. Also, many vulnerable consumers also happen to qualify as HNW and are being targeted using 'sucker lists' or via fake comparison sites. For example, elderly with dementia / isolated, recently bereaved with inheritance, people with dyslexia, people disabled by accident with compensation.

The HNW exemption is widely abused, and even when it isn't, it's no excuse. In the Connaught case, the FCA used the HNW exemption as a defence. Harmed investors argued that sophisticated, professional and high net worth individuals also have a right to be protected from fraud by the statutory regulator.

We conclude that the HNW exemption is so widely abused that it should be abolished, which we believe will require a change to legislation. Furthermore, we are pleased to note that the FCA may already be considering such a move. We base this comment on https://www.fca.org.uk/publication/call-for-input/consumer-investments-market.pdf, paragraph 4.11 onwards, which would seem to confirm that our recommendation is not outside the Overton window.

We also wish to take this opportunity to note that it is all the more worrying that the recently introduced Financial Services Bill aims to make it easier to market investment funds into the UK:

> "This measure [5] will introduce new equivalence regimes for retail investment funds and money market funds, which will simplify the process for investment funds that are domiciled overseas to market to UK consumers".

Whilst we recognise that there is also a measure to make it easier for the FCA to remove authorisation, we are not convinced the FCA would make good use of such a power; we base this comment on the general perception we have that the FCA under-utilises its powers - a very good example being the poor use of its powers under the Senior Managers Certification Regime.

It is therefore vital that the new Financial Services Bill is used effectively and that any new consumer-protection legislation that is required is passed through it - there probably won't be another opportunity as good as this for years.

Enforcement issues:

i. Without effective enforcement even the best drafted regulatory regime is of no value in achieving investor protection

Without effective enforcement even the best drafted regulatory regime is of no value in achieving investor protection. The absence of enforcement by the FCA against firms who approve Financial Promotions means that whatever the law says it will be broken unless law breakers are prosecuted.

It is a criminal offence for an unauthorised person to issue a financial promotion which has not been approved under s21 of FSMA by an FCA authorised firm. However, the FCA's annual enforcement reports reveal that no financial promotions cases were opened or closed in 2017/18 and just 3 were opened with none closed in 2018/19. *Senior sources at the FCA are saying privately that there is a legal problem preventing them from prosecuting financial promotions offences*. This was reported by The Times 19 September 2020:

> *Young people lose thousands in trading 'scam' promoted by Instagram influencers*
>
> *The Times understands that part of the reason for the inaction is a stand-off between the FCA and the Treasury.*
>
> *A source familiar with the situation said: "The FCA say privately they have a problem enforcing these laws but the Treasury say they have given the FCA strong powers to deal with this so we are at an impasse."*
>
> https://www.thetimes.co.uk/article/young-people-lose-thousands-in-social-media-trading-scam-tjw0xrldb

Hence there is no credible deterrent to prevent abuse; which means the FCA is failing to harness the fear of enforcement and thereby failing to apply the inherently resource-efficient

fear of prosecution. We make this point about resource efficiency because despite the FCA being perhaps the best resourced financial regulator in the world, a lack of resource is sometimes cited as an explanation for its ineffectiveness. We must conclude therefore that If the FCA wants to be more effective it should enforce tenaciously.

ii. The FCA does not take enforcement action against firms which approve false or fraudulent financial promotions. The FCA's response to a recent Freedom of Information request from Mark Bishop stated:

> *We have not prosecuted any authorised firms or individuals connected to them for approving the communication of misleading or inaccurate financial promotions.*

The Times: 28 July 2020 - Financial Conduct Authority criticised for failure to act over misleading promotions

> *The Financial Conduct Authority did not prosecute any authorised firm or individual over errant financial promotions between 2013 and 2019 and fined only three groups of authorised firms and individuals, according to a freedom of information request.*
> *The regulator also said it did not remove any authorised firm's regulatory permissions for approving a misleading or inaccurate promotion.*
>
> https://www.thetimes.co.uk/article/financial-conduct-authority-criticised-for-failure-to-act-over-misleading-promotions-x8sfj5wbl

Hence the current Financial Promotions Regime is archaic, opaque, not fit for purpose and open to abuse in order to facilitate scams and fraud.

It is, in effect, an invitation to scammers around the world to set up trade to prey on the UK's pensions, saving and investment market and it helps explain the pandemic-like proportions of our country's scamming problem.

Why legislation must be improved and loopholes must be closed

A basic principle of law is that anyone who wants to take part in an activity that poses a high risk to the public should be regulated. If you want to own firearms for sport, drive a car, or offer investment securities to the public, you need to register yourself with the authorities. The law does not say you cannot do it, but if you are, you have a duty to show you are doing it responsibly.

But did you know there is a loophole in UK firearms legislation that allows you to own a high-powered assault rifle, as long as you put a sticker on it saying, “This Is Not an Assault Rifle”? And that even if you start walking around in public waving your not-an-assault-rifle in people’s faces, the police will take no action until people start getting hurt?

No there isn’t, *because that would be utterly ridiculous.* Yet this is the situation that UK legislation allows in the offering of unregulated investments to the public.

Unlike firearms, collapsed unregulated schemes do not kill people, but the impact on people’s lives is often comparable to losing a limb, losing a loved one or suffering a chronic illness.

Legislation is progressively improved over time, usually after a disaster has made the failings of the existing legislation clear.

Any securities offering to the public should be registered with the FCA

UK financial services law is 86 years out of date and counting. In the United States, all investment offerings to the public are required to register with the Securities and Exchange Commission (SEC). The relevant US Securities Laws were enacted following the 1920s when companies often sold stocks and bonds on the basis of glittering promises of fantastic profits and without disclosing meaningful information to investors. Following the stock market crash of 1929, the U.S. Congress enacted the federal securities laws and created the SEC to administer them.

The Securities Act 1933[1] https://sec.report/Form/Securities-Act-of-1933.pdf regulates offers and sales of securities in the United States and requires the company to file a registration statement containing information about itself, the securities it is offering, and the offering. While registration statements are selectively reviewed by SEC staff, the SEC does not evaluate the merits of securities offerings, or determine whether the securities offered are "good" investments or are appropriate for a particular type of investor. A registration statement must be declared “effective” before it can be used to complete sales to investors.

As part of their registration they must provide accurate information on the investment offering and their financial position, certified by independent auditors. They must then file updates on a regular basis, also audited.

This does not make it impossible to run an illegal investment – nothing will. It does however make it a lot more difficult, because a) there are far fewer loopholes in what can be promoted

[1] https://en.wikipedia.org/wiki/Securities_Act_of_1933 https://sec.report/Form/Securities-Act-of-1933.pdf

to the public, and b) the requirement to publish accurate and timely information is more difficult to get around.

There is an equivalent UK requirement. It is currently derived from the EU Prospectus Regulation which requires a Prospectus for any offer of a security to the public.
The key elements of the Prospectus Regulation regime are copied over into the FCA Handbook, see: https://www.handbook.fca.org.uk/handbook/PRR/1/2.html PRR 1.2.1 copies Article 3(1) of the Prospectus Regulation which provides "Without prejudice to Article 1(4), securities shall only be offered to the public in the Union after prior publication of a prospectus in accordance with this Regulation." That requires a prospectus approved by the FCA acting as UK listing authority.

There are a number of key exemptions to the Prospectus requirement. An offer is not made "to the public" if the conditions set out in Article 1(4) of the Prospectus Regulation (see PRR 1.2.3) are met: these include (i) an offer of securities addressed solely to qualified investors; (ii) an offer of securities addressed to fewer than 150 natural or legal persons per Member State, other than qualified investors; (iii) minimum investment of at least EUR 100 000.

We are concerned that the UK equivalent requirement to the SEC is not being properly used.

The UK Government should immediately introduce legislation requiring any entity offering securities to the public (see PRR 1.2.3EU21/07/2019) to:

1. Register their investment offering with the FCA.
2. As part of that registration, provide comprehensive information regarding their business plan, existing financials, and projected cashflow, audited by an independent accountant.
3. Provide full updated accounts to investors on a six-monthly basis. No company offering securities to the public should be allowed to use "small company" exemptions from publishing full accounts. Any failure to file accounts on time should trigger an immediate investigation.

In the GPG case, no accounts were filed after 2015 but monies were poured into the scheme for a further 4 years.

The definition of a "security" should mirror that used in the US. Contrary to myth, the definition of what is and isn't a security is well-defined and has been since the "Howey Test" was established in law in 1946.

None of this is impossible, disproportionate or unaffordable - this is how it has worked in the US for decades.

Furthermore, the “restricted investor” definition (people who can have ultra-high-risk unregulated investments advertised to them if they promise not to invest more than 10% of their capital) should be abolished. It is completely unenforceable.

By making the register publicly available it could then become a ‘white list’ whereby any investment not on it would be unlawful. As such the list could be used by pension trustees, ISA managers, banks, building societies etc, to screen their clients’ transfer requests. It would also be beneficial to individual investors who could easily use it as a basis to screen out unsuitable investments.

Conclusion to Part 1

We have attempted to set out a range of pragmatic initiatives. Each initiative would make a positive difference and the combination of several if not all of them would change the scams and misleading advertising landscape beyond recognition.

Urgent and determined action needs to be taken. Each and every day that passes without adequate consumer protections being in place is leading to extreme consumer detriment.

Part 2: Our response to the specific consultation questions

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?

In principle, this would do no harm, and might possibly help a little, at the margins. However, we do not believe that this proposal comes anywhere close to being a solution to the problems described in Part 1 of our document. In particular it is unable to deal with:

- Misleading promotions approved by firms for their own use, rather than for use by unauthorised persons;
- Misleading promotions used in the UK by overseas firms passported or otherwise permitted to conduct activities in the UK;
- Misleading promotions used by unauthorised persons without first being approved by firms on the FCA register (i.e. the activities of boiler-room scammers)

Also it is unclear what additional checks the FCA would undertake and on what grounds it or the Treasury believe that such checks would be successful in identifying, *ex ante*, firms that might negligently, recklessly or dishonestly approve misleading promotions for unauthorised persons. And finally, there remains an intrinsic and inevitable problem with this scenario: a firm that approves a promotion in good faith but plays no part in the subsequent operation of the product described therein has no ability to determine or control whether that product is subsequently operated by that third party in accordance with the description provided in the promotional material.

We also wish to emphasise, for the avoidance of doubt, that any requirements and prohibitions for approving promotions of unrelated companies should equally apply to authorised companies approving promotions of unauthorised companies within the same group.

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?

Either policy option - whilst only addressing a subset of the overall problem - stand no chance of delivering any benefits if not delivered robustly. Approval to promote promotions must only be granted after appropriate justification:

- Demonstration of experience to carry out the task
- Valid reasons why it is being requested - and it is hard to envisage bone fide pro-consumer reasons why a firm would seek to provide this service for a non-related company.
- Demonstration of appropriate processes and controls - before and after approval.
- Confirmation of appropriate liability insurance

...and any failings must then have regulatory risk (financial or removal of licence) to approved firms that fail to meet these standards. WIthout punishment for failings, either option will provide no additional protection to consumers.

However, the principal risks of these policy options is that they won't work, but that they will give politicians and the public false grounds for confidence that something has been done, and that the problem has been fixed; but they won't have been. It is difficult to see benefits to the proposals, as we believe they would not address the problem.

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

As mentioned above we see neither option fully addressing all the problems, and, with inadequate enforcement there will be no benefit to consumers from either of them.

Of the two options we see Option 2 as marginally stronger in delivering a consumer-friendly result. However, we would see either as a lost opportunity to more fully address the issues we have outlined in this response in part 1.

For option 2 to make a useful difference, we consider that the following processes should be used to implement it:

- 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, within say 15 days of each approval, whereby a senior manager with responsibility for approving promotions, under the SM&CR regime is responsible for ensuring there is detailed reporting on:

    - 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 report stating the work carried out under the approval procedure and why approval was given or refused.
- The FCA should maintain on part of its website a register of all cases where approval has been given which could be accessed by interested consumers and other stakeholders. This would allow all stakeholders to be satisfied that any claims by unauthorised firms that their promotion had been approved by firm X to check that such a claim was true.
- 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.

Conclusion to Part 2

We have shown why the proposals suggested will fail.

We have stated that Option 2 is better than Option 1.

We have also indicated what would need amending in Option 2 to make it less bad.

Overall conclusion; and expression of concern

As explained earlier, we feel the questions you have posed in your consultation, namely:

> *#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?;*
>
> *#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?; and*
>
> *#3 If the government was to proceed with one of the two policy options, which would be your preference and why?*

...are unhelpfully narrow i.e. by just responding to those specific questions HM Treasury would miss the opportunity to receive what we believe to be the worthwhile additional input we can provide.

We are very concerned that most if not all of your other respondents will not take the approach we have taken i.e. they will have just answered the questions set. If that is the case, it may well be that, if you were to ignore our response, you would conclude that Option 2 was the way forward and that it would work.

But Option 2 is not the way forward; it can't work for the many reasons given; and Option 1 is of course even worse.

We therefore urge you to avoid falling into the trap of ignoring the "bigger picture"i.e. the many important points we make in Part 1 and also the worthwhile input provided during the symposium we ran on this topic on Wednesday, October 14th; for which you have a link to the video recording that can be accessed via the link on Page 3.

We hope that our input won't be ignored - it's going to be very easy to see if it has or hasn't been in the weeks and months ahead so we will watch with great interest to see what now happens.

Thank you very much for the opportunity to provide input. We are happy to provide further input if required, be that in writing or through dialogue - please just ask.

End.