Response to FCA Call for Input: The Consumer Investments Market

22 December 2020

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 43% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

The IA welcomes the opportunity to provide a response to the FCA Call for Input (CFI) on the Consumer Investments Market. Building on the many changes already implemented in the retail investment fund market in recent years, it is vital to strengthen the investing culture across the UK population and to ensure that consumers who do invest, do so with confidence in a well-functioning market. Given the extremely wide range of issues raised in the CFI, our central aim is to provide the FCA with initial views on what the scope and remit should be when looking at policy change in the consumer investments market.

We also see some of the key themes addressed within the CFI as linked to HM Treasury's current consultation on the Future Regulatory Framework, in particular how different responsibilities for saving and investment are framed through the UK's post-Brexit policy and regulatory architecture. We will be providing more detail on those points early in 2021 as part of the IA's response to that consultation.

On the important questions raised in the CFI regarding the future shape of the product market, what good disclosure looks like and how investors can be better supported, there is a central message running through our comments. This hinges on the importance of drawing on the lessons of past experience in the retail market. In particular, these lessons concern the failure of previous 'simple product' initiatives to gain significant traction; the limitations of conventional approaches to disclosure; and the rigidities of the established definitions of advice and guidance.

Instead, we support the FCA's openness to fresh thinking. By harnessing both behavioural insights and the transformative potential offered by technology, there is an opportunity to re-imagine the future experience of UK investors. We stress that this is not a job for regulators alone. Rather, it is the responsibility of industry and regulators to work collaboratively and we set out a number of areas where we think this will make a real difference. Notably:

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- Taking forward the theme of smarter digital communication, 'just-in-time' engagement and the role technology can play in this
- Considering how best to ensure that appropriate investment risk is taken
- Better deploying consumer testing to inform policy
- Changing the approach to financial guidance to allow firms to help customers make better decisions, while also ensuring the value of financial advice is understood
- Harnessing both technology and different generational attitudes more broadly to change the customer experience.

We also see an opportunity for industry to do more to change the narrative around investment itself, to change public perceptions and help encourage a wider long-term investment culture. This builds on IA research, which demonstrates significant but addressable attitudinal barriers that discourage many potential investors from even interacting with the retail funds market.

Our response also covers other areas of concern and importance to the industry, which relate to broader market efficiency and consumer trust – notably:

- The need to tackle consumer harm arising from investments outside the FCA regulatory perimeter, and a wide range of measures to effectively tackle scams, which can both result in significant individual harm and damage wider confidence in the financial system; and
- The urgent need to look again at the way in which the Financial Services Compensation Scheme (FSCS) is financed and operated.

ANSWERS TO SELECTED QUESTIONS

1. Introduction

Question 1: Have we prioritised the right issues and questions? Are there other things you think we should be looking at?

The Call for Input (CFI) raises a set of fundamental questions about how the retail investments market operates and how it should be regulated. We welcome the opportunity to discuss these questions with the FCA and work collaboratively to ensure that the market works to deliver good outcomes both for those who already invest and those who would benefit from investing but are not currently doing so.

Our response is shaped by four key messages, which we hope will help to establish a foundation for what is set to be both a complex and long-lasting workplan for the FCA and industry.

1. Clarity of Problem Statements

Given the wide range of issues identified in the CFI, our view is that the FCA would benefit from separating out some of the questions / problem statements, both to help prioritise and shape the programme of work.

Three sets of issues require urgent attention. First, the growing prevalence of scams which are an obvious source of serious harm and a threat to broader public confidence and trust in the financial system. Second, the challenges of failures in firms and products that operate outside the FCA's regulatory perimeter. Third, the growing challenge of the cost and effectiveness of the FSCS.

While fundamentally important, the challenges faced in fostering an effective long-term investment culture and the related issues of product design, disclosure, education and advice/guidance, are of a different nature to the issues raised above, although we recognise the inherent connection within the overall system of regulation. These challenges have been the subject of repeated and significant regulatory interventions over the past twenty years, including ongoing review in the case of the Retail Distribution Review (RDR) and Financial Advice Market Review (FAMR).

2. Importance of the wider policy and regulatory system

The CFI overlaps with the Financial Services Future Regulatory Framework Review (RFR), which raises the question of the framing of responsibilities through the system. We encourage the FCA to look at the CFI and RFR together. This will allow critical questions raised in the CFI, such as regulatory perimeter, to be addressed effectively. It will also allow for an important and necessary discussion about where responsibility for fostering a healthy long-term savings and investment culture should lie. In this vein, it is vital that the FCA, Government, industry and consumer groups work together to drive the savings and investment behaviour of the UK population. IA research conducted with Ipsos (discussed further below) has reinforced our view that much more needs to be done in this area, with only around a quarter of the UK population holding an investment product. Recent increases in levels of responsible and sustainable investment are one clear signal that many people, notably younger age cohorts, are ready to engage more.

Specifically to the issues in the CFI, the Financial Services Markets Act 2000 gives the FCA a very clear remit with respect to consumer protection which shapes a core focus on the reduction of consumer harm. High standards of consumer protection are absolutely critical, and the industry is very supportive of ensuring a market which is competitive, well-governed and transparent. There is also a debate that needs to take place about how to encourage and support appropriate levels of risk-taking, including an understanding of the risks of "not taking risk". We will be able to provide more detailed views on this point in our forthcoming response to the RFR.

Similarly, we look forward to inputting into the impending wholesale review of disclosure for UK retail investors as announced[1] by HM Treasury in July in the context of the future UK Packaged Retail and Insurance-based Investment Products (PRIIPs) regime.

3. Embracing new approaches to tackle core issues effectively

We welcome the FCA's recognition of the importance of the need to embrace a different approach both to education and broader consumer behaviour. In our view, the combination of a focus on consumer harm reduction with policy tools that remain too strongly rooted in a 'rational expectations' model of consumer behaviour has the potential

[1] https://www.gov.uk/government/publications/amendments-to-the-priips-regulation

to inhibit development of the retail market. One can see the risks through the lens of previous retail policy initiatives in three key areas over the past decade:

- Simple products. A number of different initiatives, notably CAT standards and stakeholder products, have aimed to address perceived complexity of financial products and terms. They have not had a significant long-term positive impact. In our view, the most important shift in the relationship between savers and long-term investment was engineered by the most unconventional of tools – automatic enrolment in the workplace pensions market. While such a far-reaching policy tool is unlikely to be the solution in the retail market, the underlying lessons around the need to reach for approaches rooted in a different approach to consumer behaviour are extremely valid.

- Role of effective communication. As we discuss later in our response, the investment management industry is wholly committed to working towards achieving effective communication with investors and there have been significant steps relating to disclosure which have been taken in the last three years in particular. At the same time, there is also evidence that over-engineering is creating significant challenges, even for well-informed readers. Professor John Kay's critique of the PRIIP Key Information Document is a warning that well-intentioned initiatives to provide more simplicity and consistency can also be highly counter-productive.[2]

- Availability of advice and guidance. The issue of access to advice and broader support for decision-making is perhaps the most significant area where policy intentions and outcomes have been most out of sync. While the RDR has helped in certain areas, notably to drive up the quality of advice, there are complex challenges relating both to levels of customer demand and to levels of supply in the advice market. This means that it is not serving as many consumers as it could if greater competition drove a wider range of advice services aimed at a broader consumer base. Furthermore, the formal distinction between advice and guidance is not well understood by retail customers and firms indicate that a different approach could significantly assist decision-making. Solutions therefore may need to focus on ensuring both that more customers can benefit from financial advice and that those not taking advice can access better support.

4. A Collaborative Framework for Policy Development

Given the wide range of lessons to be considered, we think regulators and industry can work more closely together to achieve some of the core objectives set out in the CFI. For the IA, these can be expressed in five key ambitions:

- **Take forward the theme of smarter communication and investor engagement just-in-time education**. For example, shifting from analogue regulated information documents to engaging and meaningful digital content and overall, the role technology can play to improve industry's ability to communicate and service clients. This should also include considering accessibility of information for those with specific needs, such as dyslexia (which can affect up to 15% of the UK population) and dyscalculia and other needs. Future legislative provisions should enable information to be adjusted to be more inclusive and accessible for all.

[2] https://www.ft.com/content/f1513818-fa06-11e7-9bfc-052cbba03425

- **Consider how best to ensure that appropriate investment risk is taken** in relation to reward, including enhancing understanding of wider aspects of risk (for example, inflation risk of cash savings, benefits of diversification, role of professionals in helping to manage risk).
- **Better deploy consumer testing to inform policy** (for example through industry pilots with regulatory involvement).
- **Change the approach to financial guidance to allow firms to engage individuals to think about their money and to help customers make better decisions**, while continuing a focus on the value of professional financial advice.
- **Harness technology and different generational attitudes** effectively to change the customer experience and help drive greater engagement with the consumer investment market by integrating technology into the client experience and advice process, not necessarily replacing it.

Within this, the industry recognises its own responsibilities and is already taking action in a wide variety of areas:

- <u>Communicating with Purpose</u>. The UK funds industry is heavily intermediated and is working to find better ways to explain its purpose and products and solutions to a potential customer base many times the size of the existing retail market.

- <u>High Standards of Governance and Clarity of Communication</u>. The FCA Asset Management Market Study identified a need for strengthened fund governance as well as greater clarity of objectives; delivery against objectives; and transparency of costs. Industry recognised the value of many of the remedies and continues to engage pro-actively on implementation.

- <u>Further Innovation to Deliver Better for Customers</u>. Firms are innovating to make operations and customer service more efficient as well as to ensure that products meet changing customer needs.

2. The Consumer Perspective

Question 2: Are there other underlying issues which have an impact on the consumer experience in this market that you think we should consider? What are they and how do you think they affect consumers?

Question 3: What role could or should 'just-in-time' consumer education play in helping consumers make more effective investment decisions?

Over the past two years, the IA has been undertaking detailed research on the attitude of the UK population to investment. We are currently digesting the implications of the findings to date and look forward to sharing the result more widely with regulators and other stakeholders as we move into 2021.

The research, conducted by Ipsos, shows that while there is a vast amount of information in the public domain regarding money, savings, investment and pensions, there remain major challenges to ensuring that investment – and the investment management industry - are well understood. In the first wave of research in 2018-19, just 28% of the UK population rated their understanding of investment or how to invest as fairly good or very good, compared to 58% for saving or how to save. A similar proportion (29%) felt that they know enough to choose an investment product, well below a mortgage (39%) but slightly above a pension (27%).

The Ipsos research also suggests that there are attitudinal characteristics of those who do not invest which require careful consideration by the industry and potentially regulators as part of any attempt to improve the functioning of the retail investments market. For example, there are low scores in the perception that investment is aimed at "people like me", but a much higher score in terms of openness to investment or finding the idea appealing. This links to the broader and critical issue of ensuring the industry appeals in a diverse and inclusive way across the UK population as a whole.

These findings reinforce our broad point about the need for a clear problem statement in the CFI about overall goals in terms of consumer engagement and decision-making. In particular, there are perception barriers that need to be addressed to ensure that certain groups of potential retail market consumers are investing at all.

In this regard, the IA agrees with the FCA about the need to recognise the limits to what financial education can achieve. While educational attempts to improve general financial literacy can be valuable, this may not be enough to significantly affect financial behaviour. This is for a variety of reasons, including that specific classes/training may lose impact without immediate application, and that education does not necessarily address some of the behavioural barriers to investing or saving.

Instead other approaches are needed whereby different approaches to engagement are explored, potentially combined with 'just-in-time' financial engagement and education as explored in the CFI. The key in our view is financial engagement and education that makes people more confident and willing to talk about money and engage with it and enables a consumer/investor to use that information in a timely manner and make an informed decision.

In order for this to work, the FCA should view 'just-in-time' education as an ongoing engagement process that would continue once a consumer has invested in a product, particularly for platforms and those firms with direct consumer relationships. For example, it could also be seen in the context of providing more targeted, personalised guidance to investors once they have invested, enabling them to make a timely decision. This is currently not possible within the current guidance/advice perimeter and explored more in section 3 below.

'Just-in-time' engagement and education also links to broader aspects of the CFI, including behavioural tools to engage customers, as well as the role of technology and innovation in facilitating new approaches. For example, Open Finance provides opportunities whereby greater sharing of data between providers could facilitate new ways to help customers consider their investment choices in the context of wider savings or financial behaviour. For example:

- It could help facilitate financial planning if an investor or potential investor were to have an "electronic wallet" covering his or her overall financial position, removing the need to contact a wide range of providers to collect that information

- It could facilitate connections with pensions saving through workplace schemes, potentially allowing employers to offer greater access to other savings products.

This is also echoed in the European Fund and Asset Management Association's recent report on Household Participation in Capital Markets[3] which outlines policy measures that could be taken at national and European level to encourage households to invest in capital market instruments. The measures cover financial literacy, pension policies, tax incentives and ways to measure progress.

Ultimately, 'just-in-time' financial education will most likely need to take many forms and avenues but developing a common set of principles focused on the main perceived barriers to greater long-term saving could be a good place to start.

3. Making the mass market work well

Question 4: What more can we do to help the market offer a range of products and services that meet straightforward investment needs?

Question 5: Could clearer, consistent labelling of investment products help consumers make effective decisions? Please provide examples where this approach has/has not been successful.

Question 6: What are the potential risks and benefits of standardised labelling requirements for consumer investments?

Question 7: What are the barriers to firms providing simple investment products for consumers?

Simple products

One of the central challenges with the 'simple products' debate over twenty years is what simple should mean in the context of investment risk. A simple product could be, for example:

- *A fund that invests in UK or global shares, possibly tracking an index such as the FTSE All Share.* Many of the fund products that were CAT standard in the early noughties were index trackers. Equity funds are comparatively simple in construction but expose investors to significant levels of market risk.

- *A balanced fund that invests in different asset classes, such as shares and bonds*. Such funds are often favoured by those less comfortable with taking too much equity market risk and were envisaged by the Sandler Review as part of the medium-term investment products for the stakeholder suite.

- *A fund with a specific outcome target (for example, to beat inflation)*. Such a fund might be sophisticated in terms of investment approach, for example, using derivatives to reduce aspects of investment risk, but simple in terms of objective.

[3] https://www.efama.org/Publications/KPI%20Report_FINAL%20version.pdf

- *A product with a specific set of rules with respect to key features*, such as charges or accessibility. The Sandler stakeholder products combined such features with a narrow range of investment options.

The third example in particular illustrates the interaction between "simplicity" and "understandability" – in the latter case, it is less important that an investor understands the engineering under the bonnet and more about whether the outcomes are as described to the individual and whether the product or strategy does what it says it will do.

The investment management industry recognises that the extremely wide choice of investment products available in the retail market can be a potential behavioural barrier for those seeking to invest. There are over 3,000 funds to choose from in the UK retail funds market, reflective of a competitive and vibrant industry, but there is no doubt that consumers need extensive support in narrowing down the choice, including clear accessible disclosure. One of the drivers behind the IA sectors framework is to make a contribution to the process of narrowing down those choices.

However, we do not agree that officially-designed and/or approved simple products will provide a more effective way to navigate the market. While we recognise that previous precedent should always be treated carefully, given changes in areas such as technology and generational attitudes, our view remains that previous initiatives in this area have demonstrated that product design is not a key issue in the market.

The IA is of the view that its members already offer a range of products that meet straightforward investment needs of investors. Funds are manufactured by both UK and global investment managers to meet the differing needs and demands of clients. These needs vary depending on the risk tolerance, investment horizons, ability to bear loss, objectives, knowledge and experience of clients. When distributing a fund, an investment manager must clearly set out the target market intended for its product based on these characteristics. Furthermore, investment funds are a way to enable customers to access capital markets to be able to share in the wealth generation of growing companies. Unlike direct equity or bond purchase, funds offer diversification across a range of firms/instruments and aiming to give a better reward than cash but that inevitably comes with greater risk.

Firms catering to the retail market will have their own version of a 'simple' product or solution offering to clients but that does not mean that it has to be an identical product or solution offered by two different firms. Designing the same products and solutions for the mass retail market is not the answer to encourage more people to invest their cash into savings.

Product labelling and effective communication/disclosure

The IA and its members are highly committed to ensuring that we communicate effectively with investors, that the information we give to them is comprehensible and fit-for-purpose, providing clear information, including pre-sale basis, and effective accountability on an ongoing basis. One of the central aims of the IA sector classifications is to enable retail investors to navigate the large universe of UK and overseas domiciled funds. Our sectors provide a way to divide the over 3000 funds on sale in the UK into broad groups, so investors and advisers can compare funds in one or more sectors before looking in detail at individual funds.

In the context of the FCA Asset Management Market Study, the industry agreed with the FCA that there was more to do in a number of areas, including clarity of objective and ongoing performance reporting. We undertook a project on clearer communication with the Wisdom Council and plan to do more work to develop our efforts further.

At the same time, we are concerned that in the retail funds market, there is a risk of over-engineering of regulated consumer documents that could cause confusion and not provide the clarity consumers need. The obvious example of this is the Packaged Retail and Insurance based Investment Products (PRIIPs) Key Information Document (KID), which has been subject to revision, but remains profoundly problematic. Some of the issues in the PRIIPs KID are also seen in the UK pensions market, where the same highly theoretical approach to the communication of transaction costs has been adopted, resulting in counter-intuitive results that are both difficult to understand and potentially distort wider cost data. Our view, while supporting cost transparency, is that this must be achieved in a pragmatic way. Negative or zero theoretical transaction costs, then combined with actual charges and costs, are not a successful approach.

On the question of the communication of risk, simplified approaches such as a traffic lights coding system have an obvious appeal. However, again, we would point to extensive work over many years on risk indicators which has shown that this is one of the most challenging areas in consumer disclosure where it is difficult to get the investor to see risk against reward.

In 2015 London Economics, on behalf of the European Supervisory Authorities, carried out consumer testing[4] of various risk visuals in order to inform the development of the KID as prescribed by the PRIIPs Regulation. Within that study, a risk label using similar traffic light coding system was tested. While respondents appreciated the simplicity of the label, overall attitudes about this way of presenting the product's risk were rather critical. The variant's strong similarity to an energy label or a food label made people think that it was unsuitable for a financial product and were also critical of the lack of reference to performance. On a simple traffic light coding system, the interdependency between risks and rewards were less obvious. The study also showed that respondents (mostly with low financial literacy) agreed that the colour red represents a 'danger' warning, and that this could drive investors away from higher risk products, which may be suitable for an investor. Furthermore, the variant also needed over eighty words underneath the visual to explain to investors what the label meant, therefore using half a page in total for the visual and narrative to explain one concept (risk).

The results of this study suggest that a traffic light coding system would have little benefit and could be detrimental. In order for a traffic light coding system to work, it would rely on all consumers starting from the same terms of references in terms of characteristics (ability to bear loss, risk tolerance etc. outlined above) which is not possible. To take a simple example:

- For someone investing for 5 years with a low tolerance for loss, an equity fund might be a RED.

[4] https://londoneconomics.co.uk/blog/publication/consumer-testing-study-of-the-possible-new-format-and-content-for-retail-disclosures-of-packaged-retail-and-insurance-based-investment-products/

- For someone investing for 15 years, or looking ahead longer term to retirement, it could be that an equity fund is AMBER or GREEN, although it is unclear whether managers would be comfortable reducing investment risk to such potentially misunderstood colours, even if the traffic light could be tailored.

Similar considerations would arise in all asset classes, given the wide variety of risks to be considered – e.g. inflation or interest rate risk in bond funds. This raises the point that the RAG (red, amber green) status of a product can change over the lifetime of a product as well as changing depending on the characteristics or objectives of the customer. While this can be said for any risk label, those products that would be red on a traffic light coding system could deter investors more than a high risk number on the UCITS Key Investor Information Document, for example. It is also the case that different combinations of funds may be used to provide a specific outcome in terms of overall risk, which may not be apparent from the individual risk ratings.

Simplified labelling is also not good for differentiating between products of a similar nature. For example, a diversified ISA fund offered by different providers with a different RAG status could be too subjective and too dependent on client specific needs. Simplicity of disclosure also means inevitably deciding what information to leave out which risks missing nuances on how funds are managed.

In a digital environment, it may be possible to have a more “dynamic” RAG status or risk flags for individual customers. For example, using a set of filtering questions to ask the customer about their objectives for their investment fund and then assessing whether particular funds meet those objectives. Clearly this would then be at customer level rather than disclosed at fund level. However, even here some of the challenges of a RAG approach outlined above would still apply.

Our industry is aware we need to improve how we visually communicate with consumers. While a wholesale review of disclosure is due, as announced by HMT in July, there is the opportunity to consider afresh how labelling could work better. In this regard, the FCA could build on the work done through the FCA Funds Objectives Working Group (FOWG) which, in 2017 discussed both pre and post-sale disclosure as part of the FCA Asset Management Market Study. The Market Study focussed primarily on fund manager communications but, in most cases, there is limited direct communication between fund managers and the end investor by the manager. Looking at the market as a whole and along the distribution chain as a whole when reviewing disclosure, should help to ensure appropriate outcomes.

Outcome focused approach

The CFI indicates the possibility of requiring firms to use an outcomes-focused approach, placing the onus on firms to satisfy themselves that their customers understand the products they choose. There are advantages and disadvantages to such an approach.

An outcome focused approach provides firms with the flexibility to provide customer outcomes and solutions in a way that is currently not possible, for example, due to the constraints around the definition of guidance and advice. However, key questions include who determines success and what is determined as success in terms of customer outcomes. For example, if 85% of customer outcomes are successful, is that deemed enough? Some funds, appropriately, have a different time horizon than others in which case an outcome focused assessment that uses the same time horizon will not be appropriate for all funds, but enabling firms to pick the time horizon could lead to picking the best horizon for presenting the information. Furthermore, such an approach could lead to a more litigious culture with firms pursued by customers who are not happy with their investment outcomes.

Another consideration, particularly for the investment management industry, is the intermediated nature of the distribution chain. Investment managers often do not have a direct relationship with the end client, or even know who or how many end clients there are, or how long clients have been invested for if funds are held in platform nominee accounts, which makes implementation of an outcome focused approach less straightforward to achieve. Hence the responsibilities for an outcomes-focused approach might need to be shared across the distribution chain.

As we consider the issue further, it would be very helpful for the FCA to provide examples of how they see such an approach working, what they would be expecting from firms and examples of when firms would be responsible for poor outcomes.

Investment pathways

The FCA states in the CFI it is interested in exploring whether clearer pathways, like those designed for pension drawdown, could be built to help more people benefit from engaging with the consumer investment market. Our view is cautious at this point, given how recent the pathway innovation has been, with implementation not due until early 2021 and therefore no ability to assess the results of this approach until later next year at the earliest. Choice architecture is not easy to implement, with a lot of cost and work involved in developing the systems without guarantee that investors will engage with it. At this stage, investment management firms would prefer to have the ability to innovate in terms of service delivery and to be able to personalise the customer journey (more on this below). Financial advice is increasingly about holistic advice (for example, how much someone should keep in cash, whether they need life insurance, mortgage protection etc.) and new delivery methods should reflect this.

Question 8: Do you think financial guidance can help consumers make effective investment decisions? Why?

Question 9: What are the barriers to firms providing financial guidance services?

Guidance

Financial guidance can both help consumers make effective investment decisions and play a role in wider financial planning, covering the overall financial position of individuals. However, in its current form these benefits are not being realised. There is strong appetite amongst IA members with distribution capabilities to provide guidance but guidance under the current definition makes such activity extremely challenging. In particular, personalisation should be allowed at some level in order for guidance to be useful to consumers (before they buy a product) and investors (once they buy a product).

Guidance needs to be viewed from the perspective of the consumer rather than from a regulatory point of view, equipping consumers with the necessary information to make the best financial decisions. Consumers do not know the difference between guidance and advice – if they are offered guidance they expect to be given information to help them make an informed decision but guidance in its current form can only educate an investor about factual generic information and not in any way provide them with information relevant to their circumstances.

While regulated advice has an important role to play, and should further be facilitated, options to make the guidance framework more flexible should be explored, with some limited form of personalisation possible. For example, where a platform sees an investor with a non-diversified portfolio, or investing in just one stock, after a period of time, they should be able to flag to that investor the benefits of having a more diversified portfolio (which links up to 'just in time' financial education and engagement addressed above). Current rules do not allow that engagement unless there is an ongoing advice relationship. Another example could be allowing decision trees with guidance parameters.

A large barrier to firms providing guidance is the uncertainty around the guidance/advice perimeter and firms erring on the side of caution. The FCA could explore providing resource to firms to help them navigate guidance on a case-by-case basis. The more consumers get guidance, the higher the chance of having informed investors who eventually go on to seek advice.

On a final point, we do not see a more personalised guidance process replacing the need for financial advice, particularly given the need for holistic financial planning assistance.

Question 10: Do you think straightforward financial advice can help consumers make effective investment decisions?

Question 11: What are the barriers to firms providing simple advice models?

Question 12: Should the redress model for simple advice be any different to standard financial advice? If yes, please explain.

Question 13: What do you think are the main causes of unsuitable financial advice e.g. weak competition, complex products, etc?

Question 14: How can we target and prevent unsuitable advice without imposing additional requirements on firms which provide unsuitable advice?

Advice

Advice has always played, and will continue to play, a key role in helping investors manage their finances. Improving the provision of guidance should not in any way lessen the focus on further promoting the importance of financial advice. We note that at the time of drafting this response, the FCA's latest analysis of the advice market post-RDR has just been published with significant data points on the advice market, including observations about why many consumers do not seek advice. We would welcome the opportunity to engage in detail once we have had the opportunity properly to digest these findings. For now, our comments are more general, relating to key issues as we see them.

<u>Availability and access to advice</u>

RDR introduced a significant structural change into the advice market, whereby previously bundled fund charging (fund product, distribution, advice) was unbundled with the intention of changing the incentive structures and increasing transparency along the value chain. There is now a smaller number of financial advisers entering the market focusing on a smaller number of clients with higher net worth which is more cost effective and less time intensive for the adviser community than having a lot of clients with smaller investment pots.

There is a recognition that advisers need to look at how to attract younger clients who may have small pots today but will build up wealth going forward. However, the administrative and legislative burden of onboarding a client is the same, regardless of pot size so a key question is how to provide a service to these clients for a cost that is both proportionate to the value the client receives and commercially viable for the adviser.

The same can be said for providing simplified advice – firms would be willing to provide it but the cost of servicing it is the barrier. In the long term the lack of supply of advisers is not viable, as it means only the high net worth market is being serviced and whether the responsibility lies with the regulator or another body, efforts need to be put in to promoting financial advice as a profession and a career. Increasing the supply of advisers increases competition in the adviser community which also leads to a vibrant professional market.

Technological change and customer service

The advice rules are constructed around the face-to-face model of providing advice, which still has an important role to play. However, the advice rules need to take into consideration the evolving digital landscape, which has accelerated at pace given the need to adapt to social distancing during the Covid 19 pandemic. The regulatory environment needs to better reflect technological advances and the way firms work now. As we explained in our response to the FCA Open Finance Consultation[5] we welcome the benefit identified of extending the provision of new advice and financial support services for consumers. The reintroduction of accessible advice to the mass retail market would be a welcome development, however, it should be reintroduced in a controlled and regulated manner.

Open finance could help bridge the advice gap in terms of extending the provision of robo-advice. However, it is unclear at this stage how Open Finance would lend itself to personal advice. We agreed in our response (and outline further in response to the competition and innovation questions below) that Open Finance could produce a quicker assessment of an individual's financial picture, such as a fact-find, and so could make a contribution to efficiency, which would also have some impact on cost.

It is important that a level-playing field is established regarding the provision of advice in order to mitigate against consumer harm: Third Party Providers seeking to offer advice would need to be regulated in the same way as any other investment firm or intermediary and subject to the same threshold conditions. Equally, where any regulated advice is given, investors need to be assured that the same standards of consumer protection apply to this as to any other kind of advice.

[5] The Investment Association, Response to FCA Call for Input: Open Finance, September 2020

Question 15: What role do you think there is for direct sales in a well-functioning consumer investment market?

Question 16: What protections are necessary for consumers buying direct?

Question 17: What safeguarding requirements should apply to those who distribute products to consumers through online platforms?

Question 18: Are there any products or investment decisions which bring greater or specific risks of harm when consumers buy them directly?

Buying direct

Consumers should be free to choose the channel they want to buy their investment from and the investor protections, as well disclosure to the investor, should be the same regardless of the channel, with customer-facing firms having certain responsibilities to provide information to consumers, even if someone else might be responsible for producing that information.

On a UK investor basis (where funds could be UK domiciled or overseas domiciled) in September 2020, 34% of funds had either gross sales or redemptions from a direct channel. However, overall, the percentage of gross sales through direct channels remains low, at 7.2% for 2019 and 6.6% of total gross sales for the first three quarters of 2020.[6]

Although retail consumers tend to access investment funds through a heavily intermediated market, we see a role for direct sales in a well-functioning consumer investment market, but recognise that more work is needed to support the consumer journey.

Firms have a range of responsibilities to ensure that investors have the information to help them be fully aware of the nature of the product they are purchasing and the associated risks. Currently, products will provide several pieces of documentation which detail the characteristics of the product and will detail risks in full, and in most cases, the investor will confirm that they have read and understood these documents and understand the risks.

However, there is a two-fold issue of firms providing generic wording, particularly in terms of risk warnings. First, it is very difficult to communicate the true nature of each risk, the probability of it happening and what the realisation of such a risk means in practice for investors. Secondly, investors will often confirm that they have read and understood fund documentation without having actually done so. This can lead to a risk of investment by retail consumers into products they do not fully understand. Technology could be used better to support client understanding of this. We know they are unlikely to read the documentation but the information could be delivered by voice note/video recording which may be more engaging for a client.

In terms of direct investment, firms recognise that they should ensure that the documentation provided, including the relevant pages on the firm/fund's website, is meaningful, both in terms of the fund's objective, policy and strategy, the relevant risks and

[6] The IA defines direct sales as 'Direct includes sales through a sales force or tied agents. Also private client sales of own funds'.

how the investor will be affected if these risks are realised - just as they should ensure that processes are set up so that documents are provided when consumers buy through online platforms or other channels. In the case of more complex or risky products, it may be the case that retail or less experienced investors are not permitted to invest directly into those products without having received financial advice and firms should satisfy themselves that this is the case before accepting such investments.

4. Higher risk investments

Choice for those who can afford loss

Question 19: How can we better ensure that those who have the financial resources to accept higher investment risk can do so if they choose, but in a way that ensures they understand the risk they are taking?

Question 20: How can we and the industry help consumers understand the benefits of diversifying their investments?

The discussion on higher risk investments in the CFI is focused mainly on areas outside the core focus of the investment management industry, which delivers highly-regulated investment fund products to the UK retail market. This raises questions both about the extent of the regulatory perimeter and the consistency of requirements with respect to customer disclosure in different parts of the financial services industry.

At the same time, some of the issues raised (for example, understanding the benefits of diversifying investments) have a relevance for all investment products and markets. Indeed, regulated investment funds are designed around the benefits of diversification and, with the right governance and risk controls, can offer access to a wide range of asset classes across both public and private markets. This aspect links to the role of broader education versus 'just-in-time' education and requires further consideration as part of the next phases of the FCA work.

It may be helpful for regulated products if it was clearer when products are not regulated because this reduces the extent to which there is loss of trust in regulated firms when unregulated firms/products lose money. For example, there could be some kind of badge that says the product is regulated and has FSCS protections, in order that products that are not regulated become noticed for not having a badge.

Making risks clearer

Question 21: Would more investments benefit from 'prospectus-like' disclosure, and/or the disciplines involved in this? If so, in what circumstances?

Question 22: Should more investments be subject to continuing disclosure requirements after they are issued, and what liabilities should be attached to these disclosures?

There are specific prospectus requirements for offers open to retail investors but we do not know how well these are received by retail investors or how useful they are. We are aware that recent Prospectus Regulation changes have sought to streamline the summary section of the prospectus and to make it more aligned to a fund's KIID. Therefore, with the increase of unlisted / private funds assets, it could be worth exploring whether there is a case for making disclosure between the KIID and Prospectus more similar to the benefit of the investor.

A reasonable case could be made that if something is to be sold to retail customers, then prospectus-like disclosures could bring discipline, but we know retail customers do not read current prospectus like documents, therefore, it would need something like the KIID for ease of understanding and comparison. Alternatively, instead of thinking about it in terms of prospectuses, it could be more about having information in the market place about how a particular product is constructed/works.

Ultimately, if retail customers are free to invest in unregulated products, then the key questions are which sorts of products should remain unregulated, and which would require something prospectus-like.

Exemptions to the rule

Question 23: What do you think about how the current high net worth and self-certified sophisticated investor exemptions are working in practice and the level they are set at?

Question 24: Firms: Have you relied on the exemptions recently to communicate promotions? Why did you do so? Consumers: Have you categorised yourself recently as high net worth or sophisticated? Why did you do so and what was your experience?

Question 25: What more can we do to help consumers understand the high net worth and sophisticated investor exemptions and what they mean for them in practice?

The IA agrees that this area needs further attention and the levels may need to be raised. However, it is not just a question of the current high net worth and self-certified sophisticated investor exemption levels themselves, but how firms market products and services to those investors. Just because a person has high net worth does not mean they understand the product or solution they are investing in to and therefore should be afforded less investor protection. In this regard, if the self-certified sophisticated investor exemption remains, processes and warnings need to be very clear to ensure that investors can judge whether they should be signing such an exemption.

Another approach could be to align the exemptions with the eventual outcome of the MiFID II review in terms of either adding a new semi-professional category or relaxing the criteria to opt-up to become an elective professional.

5. Regulatory protections

Question 26: How can we make it easier for people to understand the risks of investment and the level of regulatory protection afforded to them when they invest?

Question 27: What can be done to help consumers to better understand the circumstances in which they will be able to claim on the FSCS?

The CFI covers a very wide range of issues relating to coverage of FSCS and consumer understanding, and there may be merit in considering the highly extensive customer protection regime that applies to the authorised fund regime relative to some other parts of the investment market.

With respect to FSCS coverage in the authorised funds market, we recognise that the messaging is less clear than in the case of bank accounts, reflecting a wide variety of ways in which retail customers can access investment funds. We are keen to work further with the FCA and FSCS on these points.

6. Fair compensation

Question 28: What more can we do to ensure that when people lose money because of an act or omission of a regulated firm, they are appropriately compensated? (Who covers the bill for unsuitable advice)

Question 29: What more can we do to ensure that compensation is paid for fairly by those that cause the loss? (Making the polluter pay)

Question 30: What do you think should be done to help ensure that the 'polluter pays' for unsuitable advice?

Question 31: What do you consider to be the right balance of approaches to ensure we provide an appropriate level of protection to consumers?

The FSCS levy has risen dramatically and so has the proportion that the investment management industry pays. The current system does not support the concept of 'polluter pays' and effectively makes our members responsible for covering the costs of businesses over which they have no control. The investment management industry has seen a rapid increase in the FSCS levy despite its risk profile remaining unchanged. An analysis of the data (pre- pandemic) shows that as a percentage of the overall levy our levy class' contribution has increased from 3.1% (2017/18) to an indicative 31.5% (2020/21) which is currently capped and therefore we are no longer contributing to the Intermediation class.

While fully supporting the need for consumer protection, there are concerns that public confidence is impacted each time there is an occurrence of widely publicised mis-selling which results in the failure of firms and compensation, and costs are ultimately passed on to consumers. The scheme is designed to be a safety net, a compensation scheme of last resort. One of the questions that should be addressed is whether or not this is the case. This is an opportune time for a fundamental review of the levy in terms of scope, both in relation to products scope and territoriality. Consideration should be given to the role of claim management companies (CMC) and how the FSCS scheme can be marketed to consumers so that they receive the full level of compensation by dealing directly with the FSCS. Where an individual uses a claims management company this may result in them paying up to 30% of their compensation to the CMC, rather than receiving the full amount as they would if they went direct.

Our members are included in a levy class with firms of entirely different business models and practices who exhibit a very different risk profile. The risk for retail investors to suffer significant losses from the failure of a fund manager is minimal. However, the current system subjects the investment management industry to a financial burden that it can neither mitigate nor control. Within our own membership, well run advice firms have also been deeply affected by the actions of other firms that are not adequately resourced or have not taken appropriate mitigation steps. SIPP providers' failures account for 85% of costs to the Investment Provision Class, and additionally through our cross-subsidy of the Investment Intermediation class. We note, however, that the cause of the failures may not exclusively be the use of SIPP wrappers themselves but the placing of unsuitable or esoteric investment products within these wrappers. We acknowledge that there are complexities and practical implementation issues associated with introducing risk-based and pre-funded models and that these concepts have been discussed since July 2012 (CP12/16) without achieving industry consensus. The IA has offered to support the FCA in its work to build a more comprehensive picture of the market and the data needed to develop suitable risk metrics.

The paper identifies two areas of risk, small firms failing with large redress liabilities and SIPP providers. Regulatory efforts throughout the whole regulatory life-cycle should therefore be better directed at these firms. The cost of poor outcomes for consumers should be mitigated by a firm's financial resources both in relation to capital requirements and PII cover. Mechanisms need to be in place to ensure changes are reported appropriately using new or existing supervisory methods. Bad advisers need to be prevented from remaining in the industry and firms from 'phoenixing'. We are supportive of the FSCS Prevent Pillar and the FCA's work to reduce future claims, including through the sharing and gathering of intelligence and better analysis of data.

Question 32: Do you have any views on how the Appointed Representatives regime is working in practice?

The IA has no views on the Appointed Representatives regime.

7. Tackling scams

Question 33: How can people be better protected from scams?

The IA is very concerned by the increase in investors being adversely impacted by scams and is committed to ensuring that consumers are properly protected in this regard - this is an area we have been working on with members and third parties for several months. We have been having regular meetings with members whose brands have been cloned, working with our Financial Crime Committee to direct our approach. We have issued several good practice guides to our members, and a Super-SAR (Suspicious Activity Report) to the National Crime Agency. We have held training and education events for our members to ensure that they are aware of the latest developments and best practice and have worked with third parties, including the City of London Police, City of London Corporation, Advertising Standards Agency (ASA), Nominet and UK Finance to ensure that they are aware of the issue, and that the investment management sector is well informed of their roles and capabilities in tackling this issue.

Furthermore, we have had meetings with the Security Minister, James Brokenshire, to highlight the work the IA is doing to protect consumers and to stress the need for government action in targeting the facilitators of this crime, in particular online advertising. We have been working, as part of the Public Private Steering Group, with the Economic Crime Strategic Board to implement their action plan in tackling fraud issues. In working with UK Finance, we have identified opportunities for investment managers and banks to share information in tackling investment fraud and will be working with the banking community to implement these. We are also looking to work with Stop Scams UK and Ofcom to identify ways to prevent fraudsters from making use of the telecoms network to conduct their frauds. The IA continues its press campaign to: raise consumer awareness of, and resilience to, investment frauds; to improve understanding in the media, Government and Parliament of the industry's work to protect consumers from such scams; and to have online investment scam ads included within the scope of appropriate future legislation.

In answer to the question posed, there are a whole range of actions which, together, will help to protect people from scams.

- *Education of consumers*: this could be done by a range of different bodies, some of whom are already very active in this area, from Government, NGOs (e.g. ScamSmart, TakeFive), regulated firms through to consumer organisations such as Which? magazine.

- *Improved co-ordination on taking down adverts/websites etc by search engines and social media firms*: There is currently a voluntary process for this, facilitated by the ASA. However, we consider that it is important that this is put on a formal, statutory basis, with credible enforcement and punitive measures in place, should entities not comply with the law. We need a strong regulatory framework for this. Online platforms should be responsible for preventing scam content appearing on their sites and for removing it when it is reported. That would bring them into line with consumers' expectations. The Online Safety Bill seems a suitable opportunity to deliver this. By including financial harms, there is a responsibility on the search engines and social media platforms to identify and remove harmful content. The same requirement should be extended to cover the scam content defrauding people of their money and causing immense mental anguish and harm, let alone financial anguish, as for other elements of the Bill.

- *Sharing of information by regulated firms*: Firms are understandably reticent to share information with each other, given the Competition Law, GDPR and the DPA, tipping off offences etc. These mean that, even where there is a clear interest in sharing information about economic crime, firms are discouraged from doing so. A possible solution is the work being done under the Economic Crime Action Plan, information sharing working groups. It will be interesting to see what potential solutions they suggest. Another route for firms to share information is under the Super-SAR process. This was introduced into the

Proceeds of Crime Act (POCA) by section 11 of the Criminal Finances Act 2017. IA member firms have recently taken advantage of this, for the first time, to help them share and compile information for providing a solid dossier of evidence about crimes carried out by an organised crime gang to the NCA.

Sharing of information by regulated firms with law enforcement: The IA is working with Action Fraud and the City of London Police to ensure that firms are clear on who they can best provide information to link individual fraud reports, where there is evidence that they are connected. This enables the police to do their job better. The IA is also holding an educational event with members to highlight the Super-SAR and other crime reporting mechanisms that are available to them.

- *Sharing of information by law enforcement with regulated firms*: It is often said that when regulated firms comply with their reporting obligations, there is no feedback on whether the information was useful. While this 'black hole' can be discouraging, some feedback, even accepting that it may need to be aggregated or anonymised for perfectly valid legal reasons, would encourage firms in their efforts. Even better, would be feedback on the types of information that the police find useful. This would help firms focus their efforts and provide better intelligence to law enforcement agencies.

- *Prosecution of offenders:* Taking the most prolific criminals out of circulation, by incarcerating them, would considerably reduce the levels of fraud in the system.

Question 34: What do you think are the most suitable and proportionate remedies to further tackle scams and other online investment harms?

Other than those suggested in our answer to Question 33 we would suggest that the FCA consider the following:

- Improve further the process for warning consumers about these scams of which they are aware, particularly where the brands of regulated firms are being cloned. While the Unauthorised firms and individuals page on the FCA website is very useful, it is perhaps not sufficiently well known, or easy to find.
- Clarify how regulated firms, and others, can notify the FCA of brand cloning or other frauds, possibly by implementing a one-stop-shop reporting point for regulated firms and consumers to contact. A user-friendly guide about how best to handle queries could assist with this.
- Pursue its complaint with internet search engines, and any social media platforms, who host fraudulent investment ads, while taking FCA (and regulated firm) money to pay for ads warning about those ads. This would link in with the ASA scam ad reporting tool mentioned above – this is only voluntary at the moment, but could be made more robust. The FCA should also work with ASA, and get notifications of fraudulent adverts. This could link through to its list of fake firms.
- Lobby for fraudulent investment adverts to be in scope of the Online Safety Bill:

- Specifically, the Online Safety Bill should require search engines and social media platforms to implement a level of due diligence on the advertisers using their platforms to ensure they are who they claim to be.
- The Online Advertising Programme, which is considering how to limit the exposure of consumers to “harmful or misleading advertising”, which DCMS is currently considering may provide an alternative way to address the issue of scam adverts.

It is also important that the numerous silos in which law enforcement agencies work are broken down. We have had dealings with the City of London Police, the Met, and the NCA. They do not appear to be properly joined up. It would greatly facilitate the fight against fraud if they ensured that they were properly linked up, sharing intelligence and working together to target the most serious instances of fraud.

8. Competition and innovation

Question 35: What opportunities do you think can emerge for the consumer investment market from innovation?

Clearly innovation can offer benefits to consumers and can take many forms, from new fund structures such as the Long-Term Asset Fund, aimed at widening investment opportunities, to harnessing changing technology better. We would agree that innovation should be encouraged to realise clear benefits for the end-investor, such as increased efficiency, improved resilience, lower costs and better investment outcomes to name a few.

Covid-19 has seen a digitalisation drive and the rapid adoption of technology by many and at least an interest in new technologies by others. Additionally, with an increasingly technologically astute generation of investors we can see a corresponding increase in demand for innovative solutions. It is important to ensure that innovation occurs in a controlled way to protect consumers but without being too prescriptive, for example to provide the framework and principles to abide by but not govern precisely how a technology can be used.

As we see a growing interest in and adoption of new technological solutions, it is clear that those who can offer the best consumer experience and cater to increasing consumer expectations will stand to win out. Such competition can only be to the benefit of the end-investor.

Open Finance has the potential to offer real and tangible benefits to consumers and democratise access to finance – as we outlined in our response to your call for input recently. This offers an opportunity to widen access to advice, although it remains important to ensure that any advice given is suitable and tailored to an individual’s needs. As referred to above in our answer to the questions in section 3, there is a need for greater clarity on the boundaries between and definitions of formal advice, guidance and informal nudging techniques. Innovations such as Open Finance and other digital-first platforms are bringing this problem into sharper focus and there is an urgent need for clarity, in order to provide firms with the confidence they need to take their products further.

Robo-advice has had an underwhelming start, with low demand resulting in many initiatives in the sector disbanding. However, there remains great potential in this area, recognising that many customers may still prefer some form of direct interaction, which could in turn drive further development of different approaches such as hybrid models.

Distributed Ledger Technology (DLT) has been frequently cited as a potentially transformative technology. We are beginning to see more use cases in investment management become realised. It can offer significant benefits when used in a secure and transparent manner. As detailed in our recent paper[7], tokenised funds offer huge potential, with the primary benefits to end-investors including: lower costs; shorter settlement timeframes; reduction in reconciliations between fund ecosystem participants; reduction in operational complexity driving standardisation and consistency.

Partnering with FinTechs with specific offerings can help to realise the benefits technology can bring, particularly for firms who do not have the capacity to develop solutions in-house.

Even if innovation is used to enhance a firm's operational capability with no visibility to the end consumer, for example by using natural language processing to analyse lots of text-based data sources to gauge trends and sentiment in the market, it can still have a valuable impact on the investor who will benefit from how this information is used to inform investment decisions. Deep Learning also has the potential to realise benefits, for example it can be used for compliance monitoring or to optimise risk management through the analysis of large data sources to determine complex interdependencies. If technology can help firms achieve cost savings, then cheaper products and services can be provided to the consumer.

However, amongst the excitement and occasional hype it is also important to consider that innovation is most successful when there is a clear use case, or business problem that an applied tech seeks to solve. Innovation for innovation's sake can often turn sour.

Whilst innovation can result in clear benefits, it should be noted that not all firms will have the resources (financially or in terms of technical ability) to invest in new technological solutions and that whilst technology can certainly improve consumer outcomes, it is not the only way.

Question 36: What do you think are the main risks of innovation for consumers?

As referred to earlier on Open Finance, data privacy and protection is required to ensure the continued trust and confidence of consumers remains key. The principle of consent remains important and customers should be owners of their data, holding the ability to control and revoke access through a reliable mechanism.

Adverse financial impacts on consumers may occur as a result of poor or ill-informed advice or guidance, which may arise where only a partial picture of a consumer's financial life is available to the firm.

The hype curve shows that excessive and premature coverage of certain technologies can sometimes obscure the use case which can lead to rapid adoption without due consideration of the impact to the end-consumer.

[7] IA: *Tokenised funds – what, why and how*, November 2020

Similarly, an over-confidence in the technology, or an improper understanding of the technology being used can result in inadvertent risks, e.g. with AI one of the largest issues can be biased outcomes, resulting from black box algorithms and the associated difficulties with explainability. Much work has been progressing in this area led by the FCA and the Alan Turing Institute.

Cyber risk is an important consideration and it is particularly important to build 'resiliency by design' into any technology platform to ensure that both data loss is avoided as far as possible and also that the services provided to consumers are easily replaceable or delivered via an alternative method should it fail temporarily. On a similar note, any type of IT change can result in unintended disruption.

There is also a need to ensure vulnerable customers are catered for and not left behind as the world becomes more digital.

Question 37: What are the barriers to innovation and effective competition in this market?

A lack of legal and regulatory certainty is often cited as a barrier to innovation, with firms saying they are unsure on what they can and cannot do, particularly in the related areas of digital assets where associated legal questions remain unanswered.

In some respects, regulations written some time ago can be constraining. For example, the fund regulations contained in COLL should evolve to account for more flexibility, for example to explicitly accommodate tokenised funds and digital assets, and the IA's Direct2Fund proposals.

Access to data remains an important consideration (especially when using AI or Machine Learning which requires a vast amount of data on which to input into the algorithm). Larger firms can often have a competitive advantage by virtue of their access to vast reams of data. However, the struggle to access quality data is common across many firms.

Question 38: What more can we do to facilitate effective competition and encourage firms to develop innovative products and services which help consumers to invest?

Question 39: Have there been initiatives to promote innovation and competition in other countries that may be relevant for the UK?

We are supportive of Project Innovate and the FCA Sandbox as a means to address any regulatory questions and barriers to allow firms to innovate in the interest of consumers. We are also supportive of the technologically-neutral approach to regulation, focused on the outcomes, particularly for consumers, rather than the technology.

Clearly, much can be learnt from international experience and there are examples of innovation that are influencing developments in the UK: for example, the Pensions Dashboard initiative has parallels in Denmark, Sweden, the Netherlands and Australia. More broadly, the automatic enrolment initiative drew heavily on US behavioural science, albeit at a scale in the UK that has in turn become a successful example for other countries to learn from.

We welcome the recent developments in the EU to develop a regulatory framework to ensure the parameters are in place to allow for innovation to develop in a secure and clear fashion. They are currently working through a multi-pronged strategy; recently the European Commission published their Digital Finance Package which includes proposals for a Digital Operational Resilience Act and Markets in Crypto Assets Regulation. Whilst the spirit of these initiatives should be welcomed and their intention to offer regulatory certainty will certainly aid innovation, we generally advocate that regulators avoid taking a tech-specific approach to regulation. Given the pace of technological change is so rapid, efforts to focus on the technology can become quickly out-dated. By contrast, focusing on ensuring good outcomes for consumers, agnostic of the means to achieve this, we would argue is more effective to ensure that the consumer remains at the heart of the regulation.

There is also an opportunity for greater alignment internationally – technology is not domiciled anywhere. Differing national approaches can pose a real hindrance to effective innovation. We saw with the GDPR the difficulties with international data transfers as many jurisdictions adopted their own approach and we would want to prevent similar divergence. Similarly, there is a dependency on legal developments such as concluding the definitions of emerging technologies and important concepts like ownership of digital assets. Until these and other matters are resolved with certainty across jurisdictions there will be a nervousness for firms to fully embrace the technologies and innovate accordingly.

In order to regulate effectively, it is important to understand the technological landscape to be able to supply the right framework to support innovation. There is a need to provide clarity to the market on regulatory expectations and leave little room for interpretation. In the fast-moving environment in which we operate there is a need for regulators to be especially nimble and fast-paced. Such an example is the recent prohibition of selling crypto-derivatives to retail customers, and PS19/22 providing the market with guidance on when crypto asset-oriented activities will fall within the regulatory perimeter.

Continuing the theme, and rather than introducing new rules, it is possible that the existing framework with its wealth of regulation can be adapted to better support innovation. There needs to be a change of regulatory culture where innovation is prized both at policy and supervisory level rather than treated with caution. There is also the concern that the pace at which institutions can adopt new technologies could be hindered by heavy compliance overheads. Regulations should address tech-specific outcomes that could harm the trustworthiness of financial services in the long term. Ultimately, the FCA should refocus its culture to be more open to innovation and establish faster (confidential) channels to give pre-approval and engage in more public discourse on the benefits of innovation. This could be led by an FCA Board member and a public report produced.

End.