Treat with care

There are calls for the regulatory focus in the financial services industry to shift away from the authorisation of products towards the needs of investors

One of the key themes identified by the G2O and the OECD following the 2008 global financial crisis was the protection of investors and consumers. Both organisations recognised that 'investors suffered significant losses during a financial crisis that was stimulated in large part due to flawed practices and structural weaknesses of the financial institutions' and that 'consumer confidence and trust in a well-functioning market for financial services promotes financial stability, growth, efficiency and innovation over the longer term'.

It was also recognised in the G20's 2011 high-level principles on financial consumer protection that a risk to consumers arises from 'increased transfer of opportunities and risks to individuals and households in various segments of financial services, as well as the increased complexity of financial products and rapid technological change, all coming at a time when basic access to financial products and the level of financial literacy remain low in a number of jurisdictions'.

As a consequence, the focus of financial services regulation has been on the badging of authorised products, requiring disclosure and transparency, enforcing responsible business conduct of financial service providers and their authorised agents, and effecting complaint handling and redress processes to resolve disputes.

These are all very laudable aims and a big step forward, but it's time for a review.

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Time for debate?

The industry needs to debate whether or not this approach sufficiently addresses the needs of high net worth (HNW) private investors who are not wealthy enough to afford discretionary wealth management and proper advice.

There are very many HNW investors looking to live off a capital sum which is more than the average person would have but the preservation of which is essential for their future. Examples of this group include former owners of a family business, the smaller employer pension funds and retired professionals.

They need to invest in products which generate income and consequently find themselves taking on more risk in the current macroeconomic environment.

In several mature economies, risk is exacerbated by the shift from defined benefit pensions to defined contribution schemes which require the individual to take on more responsibility for their financial welfare at a time when state care provision lessens.

These people are not viewed as the traditional vulnerable consumer and are considered more than able to take care of themselves. However, this competence does not necessarily mean that they can assess the financial markets and associated risks they undertake. Doing nothing is also a risk. These are the customers whose interests need now to be addressed by the G20 and OECD investor protection programme so that the burden does not fall on the already over-burdened state.

The current approach of disclosure and buyer beware does not address the key issues of information asymmetry, lack of knowledge of risk being undertaken, lack of equivalent bargaining power and, critically, lack of proper independent advice.

Steps forward

A few regulators have been addressing the gap between the customer and the firm.

For example, the Financial Conduct Authority (FCA) led with the implementation of the Treating the Customer Fairly principle, and has more recently started to address the issue of firm and individual accountability with its implementation of the senior manager and certification regime and review of authorised firms' behaviour.

The FCA has not been afraid to address harder issues such as upgrading the qualifications of advisers, clarifying the meaning of independent and providing an alternative to advisers being remunerated by commission following the implementation of the retail distribution review in 2013.

The Australian government similarly implemented Future of Financial Advice regulatory reforms in 2013 with a ban on conflicted remuneration and asset-based fees for new retail finance products. It also added a statutory best interests duty for financial advisers with a safe harbour provision defining a set of activities which would ensure compliance with that duty.

More recently, in April this year, the US department of labor issued its final rule expanding the investment advice fiduciary definition under the Employee Retirement Income Security Act of 1974 (Erisa). The rule requires professionals receiving compensation for providing advice to individuals or to an employer with a retirement plan to act in their clients' best interests, or act as a fiduciary.

The department of labor believes the current rules lead to conflicts of interest, which in turn result in higher costs for people saving for retirement. It said conflicts lead, on average, to about one percentage point lower annual returns on retirement savings and $17 billion in losses every year.

These are all laudable steps – however, the regulatory agenda should shift from 'look, here is a bunch of products you can sell, and here is who you can sell them to' to 'look, here is a group of investors who have defined objectives they need to meet (capital protection, income for when they reduce work and provision for care in later life) and it is up to you to advise them on the products available to them to meet those needs'. The emphasis should be on advice not products and there should be a defined path of recourse where an adviser fails to give the advice of a sufficiently high standard.

Time for a fiduciary duty?

There are a number of possible solutions to bridge the gap in protection that currently exists. One may be a move towards the creation of a fiduciary duty which goes over and above the existing duty of care.

The idea of imposing a fiduciary duty has been floated before but there has not been much of an appetite for it in the UK. However, opinion is changing particularly as other countries with whom the UK competes and works alongside are beginning to discuss the imposition of such a duty – the US and Canada being two such examples.

Those who argue against the imposition of a fiduciary duty cite the increase in costs which would occur if a higher standard of care was to be adopted as the reason such a duty should not be imposed. However, the reality is that as an industry the financial services sector is already doing many of the things that a fiduciary duty would require – such as the classification of the investor, the giving of appropriate warnings and the requirement in the UK to treat the customer fairly.

It would not take a huge amount of additional effort to go that little bit further to ensure that everyone advising private investors was adhering to an agreed set of standards that represent not just best practice but exceptional practice. The UK financial services sector has the necessary skills and experience to carry out the due diligence that is required.

Time for an investor protector?

To go hand-in-hand with this might be the creation of a new organisation set up specifically to look after the interests of private investors. Financial advisers would be encouraged to join to demonstrate their commitment to excellent service standards.

At the moment, the only organisations in the UK looking out for the interests of private investors are the Consumer Association and financial media such as Moneybox, but these are concerned with products rather than advice and tend to focus on products being sold to the mass market.

> **Brexit provides the perfect opportunity for the UK to review investor protection and act as a trailblazer for other countries to follow**

There are of course financial advisers and other professionals who also want to see private investors protected to a higher degree, and they too need to have a forum which enables them to exchange their ideas, and which also feeds back to the regulator. Such an organisation could also act as a forum for the exchange of best practice by identifying problems with service standards and then seeking ways to address them.

For example, Australia has the Independent Financial Advisers Association which requires members to agree to 'no commissions, no charging fees based on volume of products sold and no affiliation with any product manufacturer'.

Training is the key to ensure greater care is exercised with private investors. This would cover training on the risks that exist and how they can be mitigated.

Accountability

The bottom line is that the market needs to get to a position whereby, irrespective of the characteristics of the individual investor, those advising on financial products need to stand up and take responsibility for proper product selection. If we look at introducing a fiduciary duty for those advising on unauthorised products first, this could be used as a pathfinder exercise to create a standard which could eventually be filtered down to those selling authorised products.

At the moment the legislation in this area is geared too heavily towards the protection of fund managers rather than private investors; and this is not just the case in the UK but in other jurisdictions too.

Brexit provides the perfect opportunity for the UK to review investor protection and to, in effect, act as a trailblazer for other countries to follow. There is a real opportunity here for the UK to set itself apart and to lead the way in safeguarding the interests of private investors.

Too much emphasis at the moment is being placed on how we can continue to sell financial products to Europe once we leave the EU, but this ignores the more pressing question as to whether the products in question are any good, particularly the sorts of products that are likely to be of interest to HNW private investors.

Time to pull instead of push?

Investors in all markets want good financial products. In the long-term there may be more benefit in working on a pull mechanism rather than a passporting push. Regardless of the Brexit negotiations, London is and will continue to be an important financial market and as such it is right that the financial services sector should take the lead on this issue.

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