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Promotion of High Risk Investments

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In relation to what the FCA regard as high risk investments, regulatory changes regarding risk warning changes came into effect on 1 December 2022 and various other changes came into effect on 1 February 2023. The FCA are taking what they describe as a "more assertive and interventionist" approach to tackling poor financial promotions and so reducing the potential for unexpected consumer losses.

With the changes now in place, we can start to see whether they will make an impact. The question perhaps though is whether they in practice preclude the offering of alternative products from investors who may in fact benefit for them and so reduce investor choice. The FCA did make various changes to the proposals they had set out in their Consultation Paper CP22/2 but have they got the right balance?

The FCA has long been concerned to maintain strict rules around what originally concerned the promotion of unregulated collective investment schemes and what more recently has concerned marketing of a wider range of non-mainstream pooled investments. With the issue of Policy Statement PS22/10 in August 2022, there is

- further strengthening of the financial promotion rules for high risk investments and
- the rules for firms approving financial promotions.

The FCA wishes to reduce the number of people who are investing in high risk products that do not reflect their risk appetite, following concerns that a significant number invest in high risk products not viewing losing money as a risk of investing and investing without understanding the risks involved.

The FCA provided an extended implementation period for most of the FCA's interventions, including on record keeping, to ensure there was adequate time to make the necessary changes. As a consequence, these changes came in on 1 February 2023 – the only exception was the main risk warning changes which came in on 1 December 2022.

Risk warnings

With effect from 1 December 2022, the new rules relating to risk warnings for financial promotions of high risk investments have taken effect.

Changing the requirements on risk warnings is part of ensuring that the consumer journey into high risk investments is not a simple "click through" process and that those accessing high risk investments do understand the risks involved. The package of measures includes strengthening risk warnings and also banning inducements to invest, introducing positive frictions improving client categorisation and stronger appropriateness tests (as explained further below).

For risk warnings:

- **COBS 4.7** is expanded markedly to put in details of how promotions of non readily realisable securities (and P2P agreements) should be formulated with specific short and severe risk warnings. Also, any financial promotion covered must not contain any design feature which has the intent or effect of reducing the visibility or prominence of the risk warnings or risk summaries.
- In **COBS 4.12**, which sets out the restrictions on promotion of non-mainstream pooled investments, similar new text is introduced in COBS 4.12.15R-4.12.29G, similarly introducing new required risk warnings.
- **COBS 4.14** is also amended in respect of promotion of speculative illiquid securities to retail clients on a similar basis.

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The FCA tested different risk warnings in consumer testing on both crowdfunding and crypto asset investments. All were shown to be effective at improving understanding of investment risk across both investment types so they chose the one that was in line with their existing messaging on high risk investments, namely the consumers should only invest if they are prepared to lose all of their money, given the wording was deemed appropriate for all high risk investments.

The standard one will be as follows:

"*Don't invest unless you're prepared to lose all your money invested. This is a high-risk investment. You could lose all the money you invest and are unlikely to be protected if something goes wrong*" (with a click through to the risk summary).

Firms might be allowed to use an alternative formulation in certain circumstances to avoid prescribing a risk warning that could be considered misleading or confusing for investors.

Certain exceptions have been accepted, for example for listed shares in investment companies subject to the rules on high risk investments. The FCA acknowledge that the risk warning and the non-mainstream pooled investment risk summary may be misleading so they are exempted from these requirements from the risk warning, personalised risk warning and risk summary requirements. The categorisation of those investments is to be reviewed in the second phase of the work intended within 2023.

The remainder of the changes came in with effect from 1 February 2023.

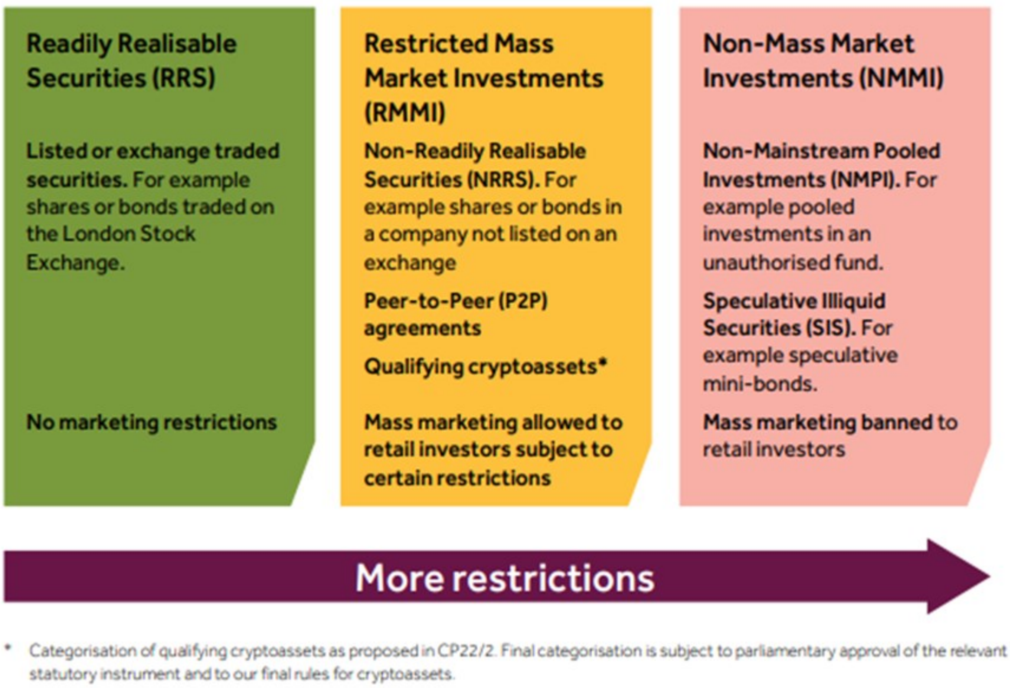
Classification of high risk investments

It is certainly true that of late the restrictions have been difficult to follow, with terms introduced over a period of time and people being unclear as to which restrictions cover what investments.

It is important now to understand the FCA's new – additional! – jargon for:

- **Restricted Mass Market Investments (RMMI) and**
- **Non-Mass Market Investments (NMMI).**

This is succinctly summarised in the following table extracted from the FCA's Policy Statement 22/10.



Source: PS22/10 page 12, Figure 2: Financial promotion marketing restrictions product categories

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The classification is not just focussed on liquidity risk but also the FCA's judgement of the riskiness of the investment taking into account a variety of factors, including credit risk, market risk, concentration risk, liquidity risk, complexity of the investment, degree of information imbalance between market participants, ability for consumers to reasonably understand the investment and whether the investment is subject to other protections which may mitigate harm to consumers.

The FCA accept that there should be some appropriate differentiation in some of the specific requirements and different guidance on expectations of appropriateness assessments because there is such a variety of investments subject to the Restricted Mass Market Investments (RMMI) category.

Units in unregulated collective investment schemes are subject to the statutory restriction on promotion in Section 238 of FSMA 2000 and are very high risk investments.

It is somewhat unfortunate that the FCA seem to treat these are inevitably at the extreme end of the spectrum. In their response in Chapter 2 of PS22/10 they indicate that such schemes "*often invest in assets which are not traded on established markets which makes them difficult to value and are highly illiquid. The risks involved are generally opaque and performance information may be unavailable or unreliable. Governance controls may be weak, heightening the potential for a product to fail. So they are unlikely to be suitable for most retail investors and it is right that their promotion is restricted to high net worth and sophisticated retail investors*."

Whilst the overall conclusion may be supportable, we suspect that several generalisations - that unregulated collective investment schemes might have weak governance controls and the other failings mentioned here – are not really very fair. Some unregulated collective investment schemes may be well governed and for particular purposes which could well suit investors in the retail space but simply do not fall within the regulated investment fund categories. Nonetheless, at least we have the status quo in terms of the Section 238 provision.

Strengthening the consumer journey for high risk investments

Various changes come under the general heading of ensuring that the customer journey into high risk investments is not a simple click through process and that those accessing high risk investments do understand the risks involved. First, the risk warning changes explained above and, in addition, the following:

- **banning incentives to invest**

  The FCA have implemented the ban on incentives, despite considerable feedback on this issue, with a net negative view on the proposed ban.

  They have though modified the rules, for example, to exempt from the ban products and services produced or provided by the issuer or borrower under the relevant investment in response to the crowdfunding sector concerns.

- **cooling off period**

  The FCA have proceeded with the proposed minimum 24 hour cooling off period for first time investors with a firm.

  There is though "clarification" on the Direct Offer Financial Promotion ("DOFP") rules for Restricted Mass Market Investments.

  The 24 hour cooling off period starts:

  - for Restricted Mass Market Investments, from when the consumer requests to view the Direct Offer Financial Promotion

    Firms must not show the Direct Offer Financial Promotion until at least 24 hours have elapsed since the consumer requested to view it. However, firms may proceed with other parts of the client on-boarding process while the cooling off period is in effect. For example, undertaking KYC/AML processes, or

  - for Non-Mass Market Investments, from when the consumer requests to review the financial promotion.

For NMMIs, the firm must not show the financial promotion until at least 24 hours have elapsed since the consumer requested to view the financial promotion but again the firm may proceed with other parts of the client on-boarding process such as KYC/AML checks.

- **personalised risk warning pop-up**

  For Restricted Mass Market Investments, a personalised risk warning pop-up for first time investors with a firm should appear before a Direct Offer Financial Promotion can be communicated. For Non-Mass Market Investments, it will appear before the financial promotion can be communicated (assuming all other necessary conditions for the financial promotion to be lawfully communicated were satisfied).

  The FCA do not believe it disproportionately burdensome to require firms to collect the name of the respondent before displaying the risk warning. The FCA are relying on their testing which showed that the proposed method of personalisation resulted in 69% of consumers clicking on the "take 2 minutes to learn more" risk summary, a 388% increase on the control treatment.

  This change is designed to complement the main risk warning – each requirement is not a substitute for each other.

  Closed-ended investment funds listed under Chapter 15 listing rules will be exempt from these requirements (as for the main risk warning requirements, as mentioned above).

- **helping clients better categorise themselves**

  It is certainly true that accurate categorisation is important to ensure customers are only exposed to promotions of high risk investments where they are capable of absorbing potential losses and where the investment is likely to be appropriate to their circumstances. Implementing an evidence component to the investor declaration forms whereby consumers are required to state why they meet the relevant criteria is therefore followed through in the final rules now introduced.

  Again, the FCA refer to their behavioural testing as to why they do not believe these requirements will be disproportionately burdensome for consumers. They indicate that a clear majority – 77% - still completed the experiment when asked to provide an evidence component as part of their declaration. Also, the FCA simply did not believe that existing declarations were working well.

- **appropriateness**

  There is a concern to strengthen the appropriateness rules for Restricted Mass Market Investments. Changes have been made for all categories of retail client for such – namely restricted, certified high-net worth, certified and self-certified sophisticated investors - unless the investor is receiving advice. (These rules would not however apply to appropriateness assessments required in other contexts under COBS 10 and 10A.)

  For Non-Mass Market Investments, self-certified sophisticated and high-net worth investors requesting to see a financial promotion must be subject to a preliminary assessment of suitability, unless the investor is receiving advice. The preliminary assessment goes one stage further than the appropriateness assessment (which is centred on whether the client has sufficient knowledge and experience to understand the risks of the investment). The preliminary assessment requires a firm to understand the client's personal circumstances, so they can assess whether the investment is likely to meet the client's needs and objectives.

- **record keeping requirements**

  With all the processes described above, it is important that the FCA can review how they work through and so there are now a number of prescribed data points for firms to collect throughout the consumer journey, so the FCA could draw on that data in any assessment of the effectiveness of the consumer journey measures.

  For the moment though, the FCA is only requiring firms to record the metrics relating to client categorisation and appropriateness assessments.

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However, the FCA thinks that other metrics which had been proposed would be useful for firms and suggests that firms consider collecting them as part of their monitoring obligations under the Consumer Duty. The FCA is taking the view that they will look at how these proposals are implemented alongside the Consumer Duty implementation and, if they think a more standardised approach is needed in future, they will revisit introducing a set of metrics for firms to record on top of those already collected under the Consumer Duty.

Strengthening the role of firms approving (Section 21 approvers) and communicating financial promotions

Whilst the longstanding ability for financial promotions to be approved by an authorised person remains, the FCA's changes considerably increase the role to be played by any such authorised firm approving a promotion. The strengthening of the rules include the following changes:

- **competence and expertise**

  The rules now require that requires firms to self-assess whether they have the necessary competence and expertise in an investment product or service before approving or communicating a relevant financial promotion.

- **approver name and approval date stamp**

  All approved promotions should include the name of the authorised firm approving the promotion as well as the date of approval.

  The only change from the proposals in CP22/2 as a result of the consultation process is that there is a minor amendment to the proposal for requirements to display the name of the approver and date of approval on a promotion.

  The standard requirements can be replaced with text referring to the authorised firm's FRN (Firm Reference Number), where space limitations imposed by a third-party marketing provider do not allow the display of the full name of the approver firm, and the date of approval. This is only though on the basis that the text is clickable and must open to a page where the firm's full name and the date of approval will be displayed.

- **ongoing monitoring**

  The rules now require an approver to play a more active role in ensuring that the approved promotion remains compliant for the lifetime of the promotion, not just at the initial single point in time.

  An approver firm will be required to obtain attestations of "no material change" from a client with approved promotion every three months for the lifetime of the approved promotion.

- **assistance for appropriateness tests**

  A Section 21 approver's responsibility for ensuring compliance with the appropriateness rules is not limited to a one-off assessment on approval of the promotion, with Section 21 approvers to take reasonable steps to ensure that the relevant processes for appropriateness tests comply with the FCA rules for the lifetime of the promotion.

- **conflict of interest requirements**

  The conflict of interest obligations are extended to firms approving financial promotions for unauthorised persons and to firms confirming compliance of a financial promotion for an authorised firm. The FCA's intention is to stop an approver gaining a competitive advantage over rivals by reducing the likelihood of anti-competitive behaviour by ensuring that firms take all appropriate steps to identify and manage conflicts of interest.

- **approving promotions for Non-Mass Market Investments**

  The FCA is clarifying its existing requirements of approvers in client categorisation and preliminary suitability assessments for Non-Mass Market Investments. The requirements reiterate that firms approving financial promotions for Non-Mass Market Investments must undertake a preliminary assessment of suitability before a firm can communicate a promotion to high net worth or sophisticated investors, based on the client’s profile and objectives.

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Overall, one can see that the strengthening of the role for firms approving financial promotions is likely worthwhile. However, we go back to the initial question posed at the beginning of this Briefing Paper: overall, do all of the changes now implemented pursuant to Policy Statement 22/10 achieve the right balance?

It remains to be seen whether the new classification of high risk investments and additional risk warnings and initiatives to "strengthen the consumer journey" for such achieve the desired effect, and can do so without unnecessarily reducing investor choice.

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