

# **Strengthening our financial promotion rules for high-risk investments and firms approving financial promotions**

**Discussion Paper**

DP21/1

April 2021

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# 1 Introduction

## Why we are seeking views

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- 1.1** We aim to deliver a consumer investment market that works well for the millions of people who stand to benefit from it, helping them to invest with confidence and save for planned and unexpected life events, and for the businesses in the real economy for which it provides essential funding.
- 1.2** So we published our [Call for Input](#) on the Consumer Investment Market (Cfi) which closed on 15 December 2020. This followed the announcement, as part of our [Business Plan 2020/21](#), that consumer investments would be a priority for us. The [Business Plan](#) set out the aim to build on our existing programme of work to change the consumer investment market. We want consumers to have access to investment products that are appropriate, and to be able to make effective investment decisions. We also want the firms we authorise to operate to high standards.
- 1.3** Central to achieving our aim is addressing the harm to consumers from investing in inappropriate high-risk investments which do not meet their needs. This can lead to unexpected and significant losses for consumers. Long-term social and economic changes, many of which have been accelerated by the COVID-19 pandemic, have resulted in more consumers using high-risk investments. This has been exacerbated by technological advances that mean these products are now more accessible and easier to invest in. As a result we are seeing more consumers who are new to investing buying high-risk investments, despite a majority being unable to cope with large investment losses and self-assessing as having a lower investment risk appetite. Chapter 2 goes into more detail on these trends and the consumer experience in this market.
- 1.4** A key theme in responses we received to the Cfi was the need to further segment high-risk investments from the mainstream market, and to further disrupt consumers from investing in inappropriate investments that do not meet their needs.
- 1.5** One of the main ways consumers build their understanding of the risks and regulatory protection associated with an investment is through the information they are given in a financial promotion when thinking about whether to invest. For high-risk investments a good financial promotion may not be enough to ensure that consumers are adequately protected. A financial promotion may meet our requirements to be fair, clear and not misleading, but the underlying investment may still be inappropriate for many investors and not meet their needs. In these cases, we can use our financial promotion rules to apply further protections for consumers.
- 1.6** Given the importance of addressing the harm from high-risk investments, we are publishing this DP now so we can move forward in developing proposals to address this harm. We want to use this DP to help us calibrate rule changes we will propose later in the year. This is important to help us understand what is feasible for firms to implement, how to strike the right balance between protecting consumers and consumers taking responsibility for their own actions and identifying any unintended consequences of these changes.

- 1.7** This DP follows, and should be considered alongside, our recent interventions to address harm from high-risk investments, including banning the mass-marketing of speculative illiquid securities, our new Investment Harms campaign which uses online advertising to disrupt investors' journeys and our ongoing supervisory and enforcement action to address harm in this market (as detailed in our Consumer investments data review 2020).

## Scope of this discussion

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- 1.8** The issues discussed in this DP primarily relate to financial promotions for high-risk investments. We explain what we mean by high-risk investments in paragraphs 2.18 to 2.29 below. But in summary we consider any investment which is subject to marketing restrictions under our rules to be a 'high-risk investment'. This includes non-readily realisable securities (NRRSs), peer-to-peer (P2P) agreements, non-mainstream pooled investments (NMPs) and speculative illiquid securities (SISs).
- 1.9** However, the issues discussed in chapter 3 are also relevant to issuers of listed and exchange-traded securities which are classified as readily realisable securities (RRSs) (in particular paragraphs 3.29 to 3.36) and the issues relating to risk warnings discussed in paragraphs 4.23 to 4.33 below are also relevant to a wider range of investments.
- 1.10** In addition, the issues discussed in chapter 5 are relevant to any financial promotion issued by an unauthorised person which is approved by an authorised firm, whether for a high-risk investment or otherwise.

## Who will be interested in this discussion?

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- 1.11** This discussion will be of particular interest to:
- consumers and consumer organisations
  - authorised firms which approve financial promotions for unauthorised persons (section 21 approvers), whether for high-risk investments or otherwise
  - issuers of non-mainstream pooled investments, speculative illiquid securities and non-readily realisable securities
  - investment-based crowdfunding (IBCF) platforms and other intermediaries distributing investments to consumers
  - peer-to-peer platforms
  - trade bodies for the IBCF and P2P sectors
- 1.12** This discussion will also be of interest to:
- issuers of listed or exchange-traded securities, and trade bodies for these issuers
  - investment companies, and trade bodies for this sector
  - issuers of other types of investments
  - firms operating in the cryptoassets market
  - financial advisers

## What we are discussing

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- 1.13** We want consumers to be able to make effective investment decisions. Consumers need to be able to understand and assess:
- the features of the investment
  - the costs they are likely to incur
  - the risks they might take and the benefits they could derive from the investment
  - whether the investment will meet their needs
- 1.14** It is therefore crucial that firms' communications are specifically designed to give consumers the understanding they need, in terms of what information is provided, how it is provided and when it is communicated. We already require firms to ensure that financial promotions are fair, clear and not misleading, but in the case of high-risk investments in particular, this requirement alone may not be enough to protect consumers.
- 1.15** High-risk investments come with a far greater likelihood of losing money than more straightforward mass-market investments, for example, through stocks and shares ISAs, and often have added complexity. But consumers often can't tell the difference between these different types of investments and tend to focus more on the promised returns. For example, [FCA research](#) found that consumers only start to recognise that a financial promotion for an investment product is probably 'too good to be true' when the promised rate of return is around 30% or more. This is despite the fact that the current rate of return on a cash ISA is around 1% per annum and consumers should be wary of returns offering significantly more than this.
- 1.16** As we explained in the Cfl, we think that most retail investors' needs can and should be met by straightforward, mass-market investments. However, we recognise that higher-risk investments can have a place in a well-functioning consumer investment market for those consumers who understand the risks and can absorb potential losses.
- 1.17** Even where it might make sense for someone to take more risk, consumers should be spreading their money across a diverse range of investments. This is to avoid a significant loss if a single investment, or type of investment, fails. But we have seen instances where consumers have put all their money into a single, high-risk investment and then lost all their money when things go wrong. We have also seen consumers buying investments with very high upfront fees which significantly reduce the chances they will make the promised returns or any returns at all.
- We already use a broad range of tools to address the harms from high-risk investments using our financial promotion rules, as set out in Chapter 2. However, we believe more needs to be done to address the harms we see.
- 1.18** Based on responses to the Cfl and other evidence sources, we have identified three main areas where we could strengthen our rules.
- **Our classification of high-risk investments (chapter 3):** Our classification determines the level of marketing restrictions that apply to an investment. We want to ensure that we capture all investments that pose the highest risk to consumers and that investments with similar characteristics are treated in a similar way to prevent arbitrage. So, we are asking whether you think there are any investments which are not subject to marketing restrictions which should be. We are also asking for views on potential changes to the current classification of certain types of

investments and consequently the level of marketing restrictions that apply to them. For example to prevent opportunities for arbitrage in the context of our rules for SISs and potential changes to the definition of an RRS for the purposes of our financial promotion rules.

- **Further segmenting the high-risks investments market (chapter 4):** We are concerned that despite our existing marketing restrictions, too many consumers are still investing in inappropriate high-risk investments which do not meet their needs. Therefore, we plan to strengthen our rules to further segment high-risk investments from the mainstream market. We are seeking views on certain aspects of this. For example, what can be reasonably done to strengthen the investor categorisation process where access to a financial promotion is restricted to certain types of investor? What are the most effective improvements we can make to risk warnings? And how can we most effectively introduce more 'positive friction' into a consumer's journey for high-risk investments?
- **The role of a section 21 approver (chapter 5):** Section 21 approvers approve financial promotions for unauthorised persons and check for compliance with our rules. Given the key role that they play in ensuring that financial promotions meet the standards we expect, we think that they should also have clear responsibilities to ensure compliance on an ongoing basis. We are asking for views on what these responsibilities should look like.

**1.19** When making interventions, we need to have regard to the regulatory principle that consumers should take responsibility for their own decisions. However, we know there are factors that might limit consumers' ability to make effective decisions. We also want to ensure that consumers have the information they need to make an effective decision and that they are not rushed when they do so.

**1.20** As we noted in the CFI, it's hard to gain a clear picture of the number of consumers affected in this area because we often do not regulate the issuers of high-risk investments. So, we may not regulate the firm a consumer is dealing with unless there is an authorised intermediary. We are therefore also asking for any additional insight into this market to help us decide future changes.

**Q1:** Please provide any data related to:

- a. the number of consumers who currently hold high-risk investments, the amount they hold and the type of high-risk investments they hold
- b. the number of issuers of high-risk investments, the amount they issue and the type of high-risk investments they issue

## Next steps

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### What you need to do next

- 1.21** We want to hear your views on the issues discussed in this DP. Please send any comments to us by **1st July 2021**, using the online response form on our website.

### What we will do next

- 1.22** We will continue to consider what changes we should make to our financial promotion rules to support the outcomes we seek for consumers, as described above. In addition to considering the responses we receive to this DP, we propose to undertake testing of ideas informed by behavioural research, some examples of which we discuss in chapter 4, to get better insight on how effective they might be. Following this, we will consult on proposed rule changes later this year.
- 1.23** Separately, we will publish a full response to the Cfi, together with the next steps of our wider consumer investment strategy, later in the year. Alongside this, we will also publish the second summary of our work to tackle harm in the consumer investment market, covering our activities up to the end of the financial year 2020/21.

## 2 The wider context to this discussion

### The consumer experience

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- 2.1** Long-term social and economic changes have made the consumer investment market more important than ever. Consumers are increasingly responsible for making complex decisions about how they invest their long-term savings for life events and to enjoy in later life. There is more choice of products and services than ever before.
- 2.2** This greater choice has many benefits but can sometimes be complex for consumers to fully understand, which increases the risk of things going wrong. Low interest rates have driven a search for higher returns, drawing more consumers towards riskier investments and making it harder for consumers to understand when an investment is too good to be true. Additionally, advances in technology have made high risk investing more accessible. There is now a high prevalence of online adverts, as well as low cost/ no fee online investment platforms.
- 2.3** The pandemic has accelerated many of these trends. Our Financial Lives survey data suggests that 6% of adults with investments increased their holdings of high-risk investments during the pandemic, despite a widespread increase in consumer vulnerability.
- 2.4** There is also growing investor demand for green financial products and services. This stems from increased awareness and understanding of the impacts of climate change and of the role the financial sector can play in supporting the transition to a greener economy.
- 2.5** Alongside this, there seems to be a generally low level of understanding of the risks of investing. For example, in research we commissioned, 45% of self directed (i.e. non-advised) investors said they did not view 'losing some money' as a potential risk of investing. This was particularly acute among those that had invested in the high-risk end of the market.
- 2.6** The research also points to a new emerging group of investors, that have significantly different characteristics in comparison to more traditional investors. New investors (those that have been investing for less than 3 years) are more likely to use online investment platforms than longer standing investors, and research investments using less traditional sources of information such as social media.
- 2.7** More information on the consumer research we commissioned can be found in paragraph 4.6 below.

### The existing regulatory landscape

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- 2.8** A financial promotion is an invitation or inducement to engage in investment activity (or claims management activity), that is communicated in the course of business. They



can take a wide variety of forms, including adverts placed through print, broadcast or online media, marketing brochures, e-mails, websites or social media posts.

**2.9** The financial promotions regime consists of three core elements that work together to govern the marketing of financial services.

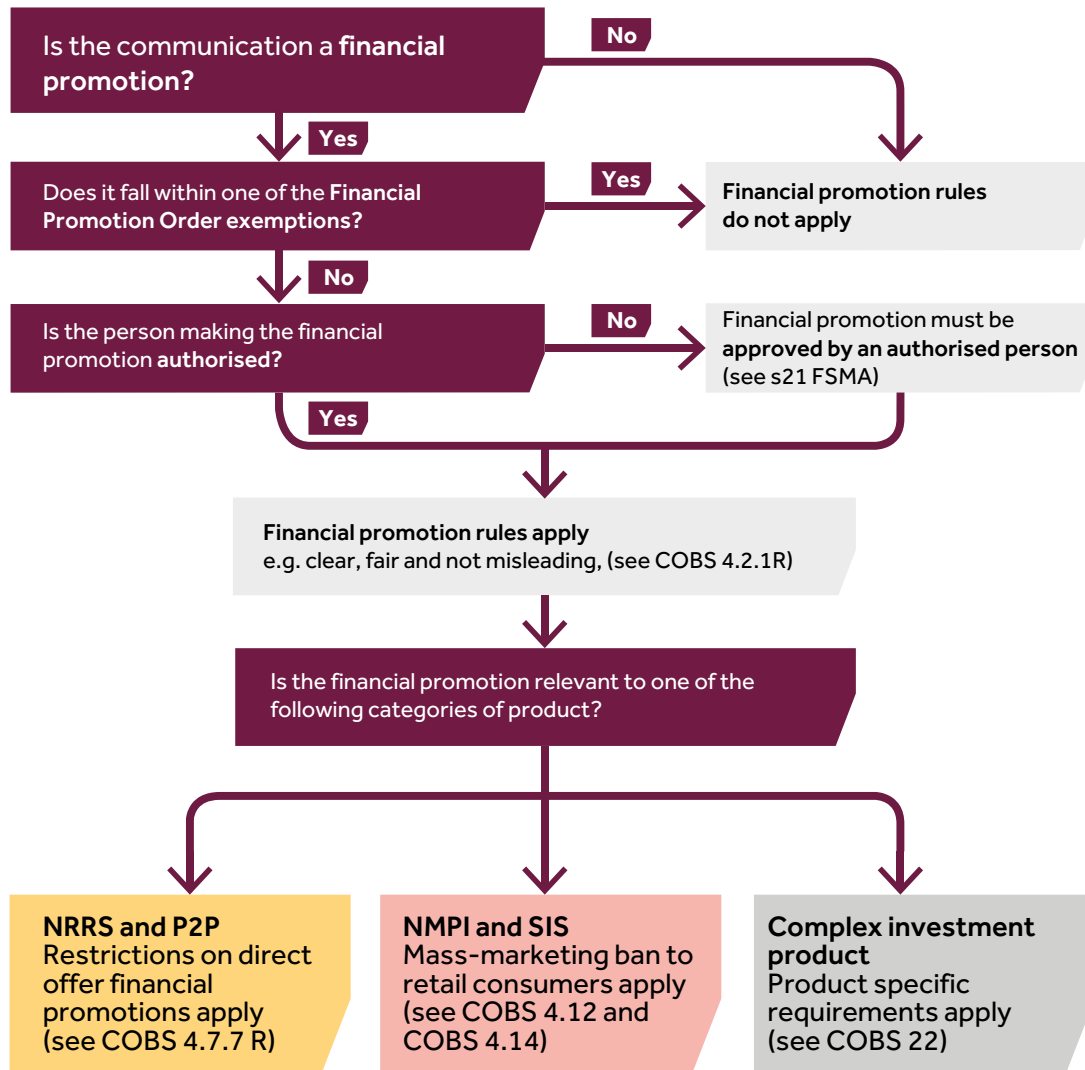
- Section 21 (s21) of the Financial Services and Markets Act 2000 (FSMA) sets out 'the financial promotion restriction', which prohibits the communication of a financial promotion unless it is communicated by an authorised person, or the content has first been approved by an authorised person. A breach of s21 is a criminal offence.
- The FSMA (Financial Promotion) Order 2005 (FPO) includes a number of exemptions from the financial promotion restriction in s21, which permit an unauthorised person to communicate a financial promotion in certain circumstances and subject to certain conditions.
- FCA Handbook rules prescribe the requirements relating to financial promotions that apply to authorised firms which communicate or approve them (financial promotion rules). For the purposes of this DP, the relevant financial promotion rules are set out in COBS 4, while there are specific rules for promotions of other types of financial products and services in other sourcebooks. Our rules ensure that financial promotions meet minimum standards so consumers can make well-informed decisions. The financial promotion rules also apply marketing restrictions to promotions for certain types of investment (see paragraphs 2.18 to 2.29 below).

**2.10** We have limited powers over many issuers of high-risk investments because they are often not carrying out a regulated activity when they issue an investment product, and so are unauthorised persons. In particular, this means that we cannot generally impose requirements on the issuers of high-risk investments themselves as these issuers are often not subject to our rules.

**2.11** However, we can make rules on how they market their investments. These apply when an authorised firm approves or communicates the financial promotions related to those investments. We can also make rules which apply to firms when they carry on regulated activities by intermediating the sale of these investments. Figure 1 provides a high-level overview of when our financial promotion rules apply.

**2.12** We carry out extensive work to ensure compliance with our rules, including checks at the gateway, ongoing supervision and enforcement action. For more information on this activity see our Consumer Investments Data Review 2020.

**Figure 1: Do our financial promotion rules apply?**



## The three routes to communicating a financial promotion

- 2.13** There are three routes that can be taken to communicating a financial promotion. First, authorised firms can communicate their own financial promotions but must comply with FCA Handbook rules. This includes the overarching standard that a financial promotion must be fair, clear and not misleading, and any marketing restrictions which apply to particular types of investment (see paragraphs 2.18 to 2.29 below).
- 2.14** Second, authorised firms can approve financial promotions for communication by unauthorised persons. The authorised firm must only approve the financial promotion if it complies with the same FCA Handbook rules described above and must withdraw approval if it becomes aware that the promotion no longer complies. Our Handbook rules and guidance for section 21 approvers are supplemented by our guidance for section 21 approvers published in November 2019.
- 2.15** Third, unauthorised persons can communicate financial promotions without any approval if they comply with the conditions of an exemption in the FPO. If a promotion can be made within the scope of an exemption, our financial promotion rules do not then apply to that promotion.

## The FPO exemptions

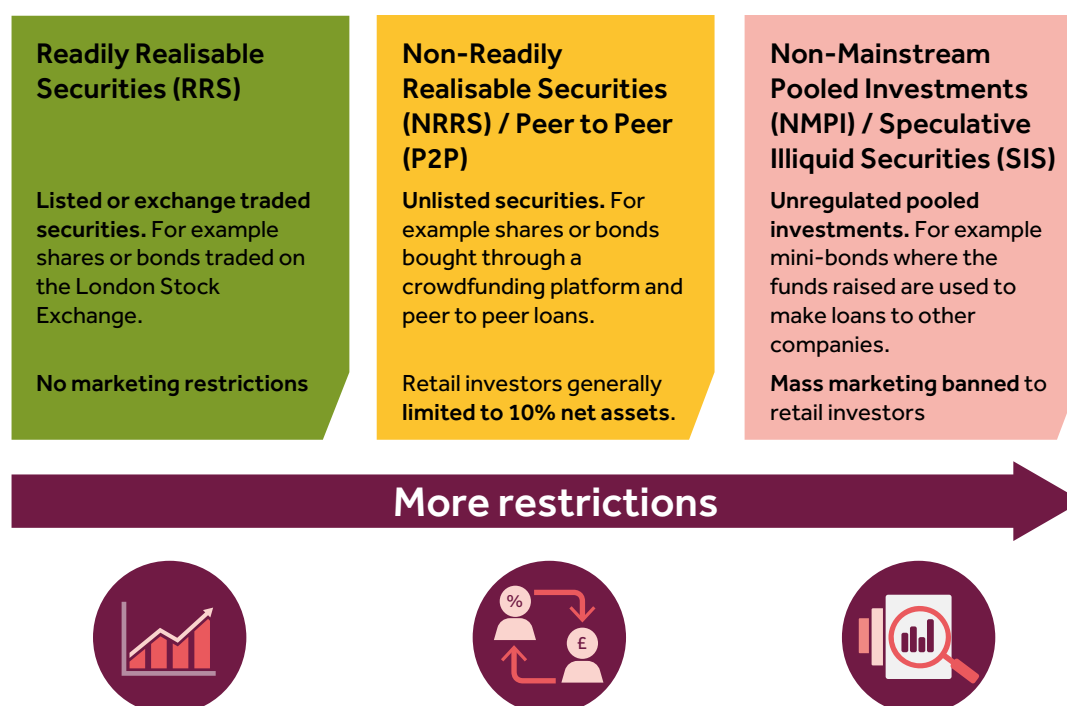
**2.16** Some commonly used exemptions in the FPO are those for promotions to 'high net worth' and 'sophisticated' investors (which we call the 'FPO exemptions' in the rest of this DP). Unauthorised firms can communicate financial promotions for certain types of investments without regulatory oversight, provided they only promote to investors that satisfy the criteria for these exemptions and otherwise satisfy the conditions for the exemption to apply.

**2.17** We have discussed these exemptions in detail in the [CfI](#) (see chapter 4) and our [2019/20 Perimeter Report](#). While this DP discusses possible changes to our rules, these changes would have no impact where an unauthorised person relies on an FPO exemption to promote investments. Any changes to these exemptions are a matter for Government. However, we must bear in mind the exemptions when considering changes to our rules as changes could lead to an increased use of the exemptions. For example, since we introduced our SIS rules at the beginning of 2020, unauthorised persons issuing such investments have increasingly relied on these exemptions to promote them, rather than relying on approval of promotions by an authorised person. Before the SIS rules, approximately 20% of the websites we reviewed had been approved by an authorised person. Since August 2020 this figure has dropped to almost 0%.

## Marketing restrictions for high-risk investments

**2.18** For high-risk investments, a good quality financial promotion is not enough to protect consumers from making inappropriate investments. A financial promotion may meet our requirements such as being fair, clear and not misleading, but the underlying product may still be inappropriate for most retail investors and not meet their needs. To mitigate this risk, our financial promotion rules apply varying levels of marketing restrictions to financial promotions for certain types of investment. Figure 2 provides a high-level overview of these restrictions and the investments they apply to.

**Figure 2: Financial promotion marketing restrictions product categories**



**2.19** Readily realisable securities (including listed and other exchange traded securities) can generally be promoted to the mass market without restriction under our rules. However, the types of investment discussed in 2.20 to 2.28 are subject to marketing restrictions under COBS 4 where an authorised firm communicates or has approved the promotion. COBS 22 also contains restrictions on the distribution of certain complex products. We consider investments covered by these restrictions to be 'high-risk investments'.

***Non-readily realisable securities (NRRSs) & peer-to-peer (P2P) agreements***

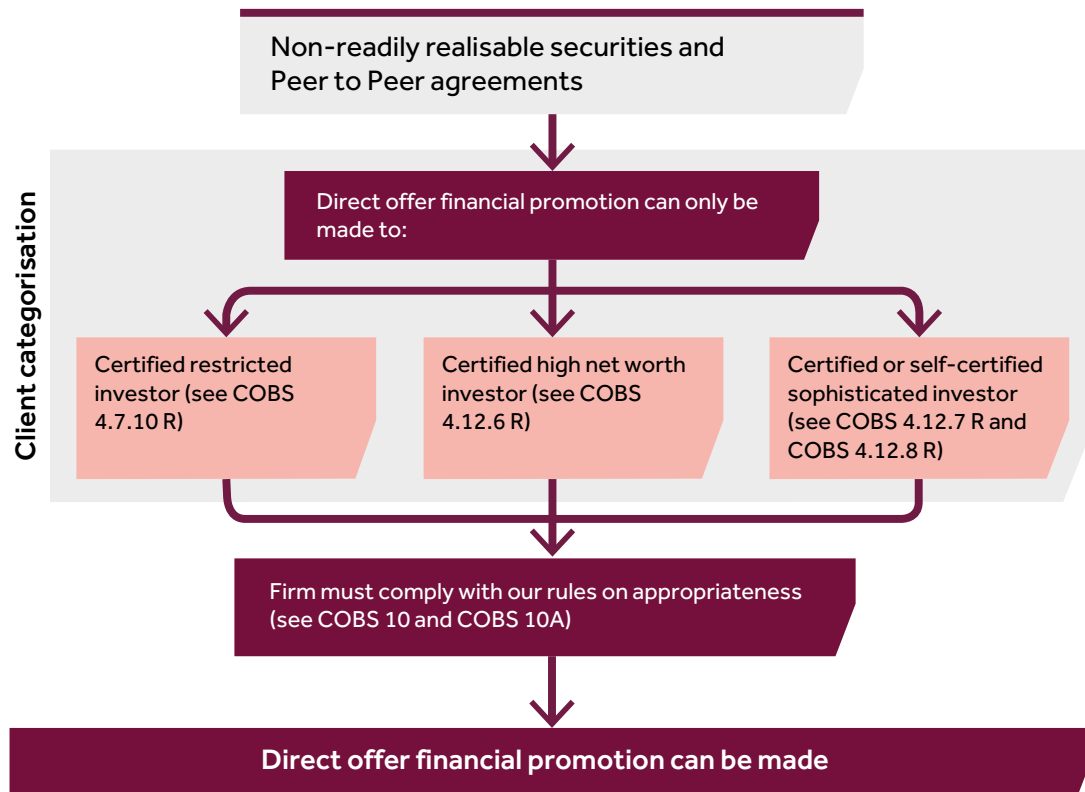
**2.20** NRRS are, very broadly, unlisted and non-exchange traded shares or bonds. They can be sold either directly by the issuer or through an intermediary such as a crowdfunding platform. P2P agreements are entered into via a P2P platform.

**2.21** These investments can generally be promoted to the mass market. However a 'direct offer financial promotion' which, in general terms, specifies the manner of response or includes a form by which a response may be made, cannot be mass marketed unless certain conditions are satisfied (although these do not apply where the investor is being advised). Figure 3 provides a high-level overview of how these investments can be marketed under our rules.

**2.22** Firstly, the recipient of such a promotion must be categorised as either a certified high-net-worth investor, a certified sophisticated investor, a self-certified sophisticated investor or a certified 'restricted' investor according to our Handbook rules. To be a restricted investor, the individual must sign a declaration to say they have not in the last 12 months, and will not in the next 12 months, invest more than 10% of their net assets (subject to certain assets being excluded from this calculation) in these types of investments.

**2.23** Secondly, our Handbook rules on appropriateness must be complied with. These rules require consideration of the investor's knowledge and experience in the relevant investment field, to enable an assessment of whether the product is appropriate for that investor.

**Figure 3: Can NRRSs or P2P agreements be marketed under our rules?**



### ***Non-mainstream pooled investments (NMPIs) & speculative illiquid securities (SISs)***

**2.24** An NMPI includes the following investments:

- a unit in an unregulated collective investment scheme (UCIS)
- a unit in a qualified investor scheme (QIS)
- certain securities issued by special purpose vehicles
- a traded life policy investment

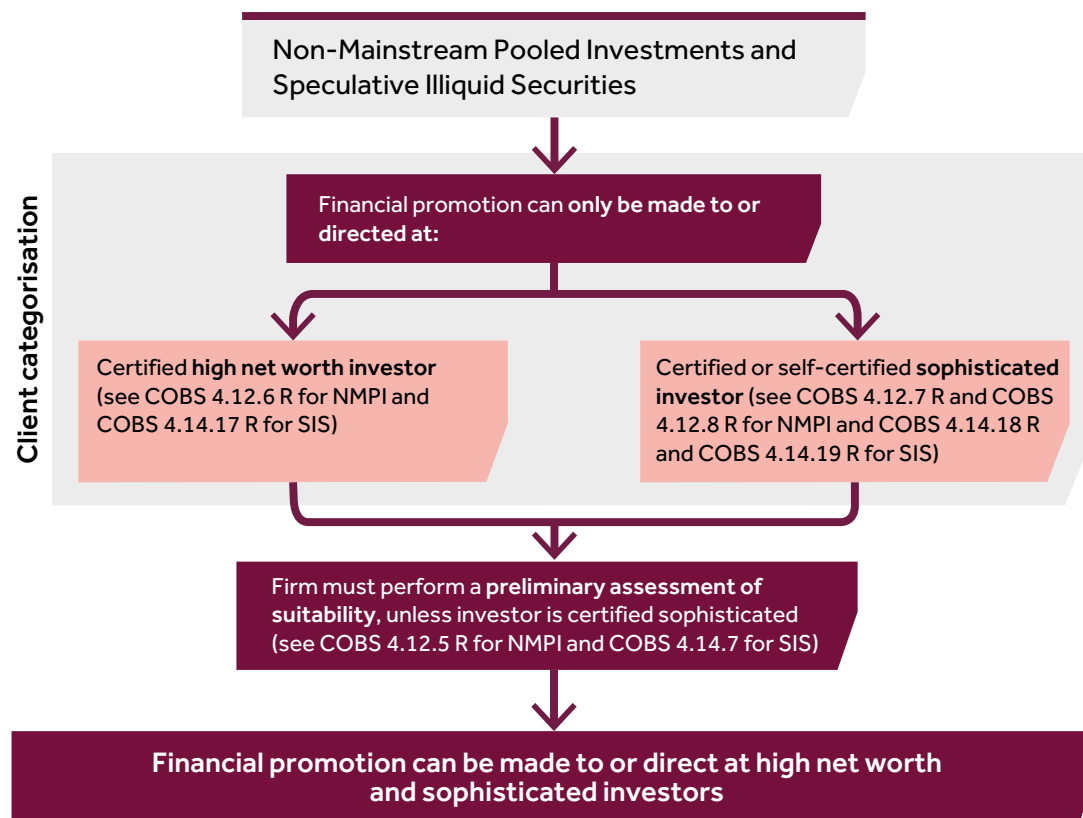
**2.25** A SIS is a debenture or preference share where the proceeds are used for on-lending, buying or acquiring investments, or buying or funding the development of property. While listed securities are generally not SISs, a listed debenture that meets the definition of a SIS and is not regularly traded, is also caught by the SIS rules.

**2.26** The mass-marketing of NMPIs and SISs is not permitted. They are generally not suitable for retail investors as they are high risk and often complex and difficult for investors to understand. The mass-marketing ban means that retail investors should not be able to see promotions for these types of investment, unless they have first been categorised as high net worth or sophisticated investors as described below.

**2.27** Figure 4 provides a high-level overview of how these products can be marketed under our rules. Financial promotions of NMPIs and SISs communicated or approved by an authorised firm can generally only be made or directed at certified high net worth, certified sophisticated and self-certified sophisticated investors. This must also only be after the firm has done a preliminary suitability assessment for certified high net worth and self-certified sophisticated investors. This requires a firm to acquaint itself with the investor's profile and objectives, to ascertain whether the investment is likely to be suitable.

- 2.28** For SISs, we have also introduced rules to improve disclosure of key risks and costs to the limited number of retail investors who are still eligible to receive promotions for these types of securities (see paragraph 4.29 below).

**Figure 4: Can NMPIs or SISs be marketed under our rules?**



### **Specific complex investment products**

- 2.29** In addition to the categories described above, in COBS 22 we have applied restrictions to specific complex investment products, including restricting sales where possible. This is not a unified category, but sets out restrictions where we have intervened in response to specific harms. For example, we have banned the sale, marketing and distribution of crypto asset derivatives and binary options to retail clients. We have also placed standardised risk warning requirements on the marketing of contracts for difference to retail clients, along with other specific requirements in relation to these products.

## **Online harms**

- 2.30** Fraud now accounts for one-in-three crimes in the UK, costing up to £190 billion a year. 86% of fraud is committed online and this problem is growing. Online platforms, such as search engines and social media platforms, play an increasingly significant role in communicating financial promotions to consumers. As a result, consumers are being more readily exposed to adverts, ranging from scams and promotions of high-risk investments to false or misleading adverts. Directly or indirectly, this leads consumers onto paths resulting in harm. As the digital world continues to develop, the potential harms to consumers change in both nature and severity.

- 2.31** We continue to work with online platforms to see that they rapidly deliver on their public commitment to prevent harm from online advertising through taking a more proactive role in stopping scams and vetting the content they host. We also proactively monitor these platforms ourselves to identify illegal or misleading promotions and issue alerts on our website and through Scamsmart where appropriate. We strongly believe financial harm should be included within the Online Safety Bill, to ensure consistent, enforceable standards and greater protection for consumers.

## Related developments

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### The Treasury's consultation on the regulatory framework for financial promotion approvals

- 2.32** In July 2020, the Treasury proposed a new gateway through which authorised firms would need to pass to be able to approve the financial promotions of unauthorised firms. We think this proposed change is an important step in the right direction and believe that this is the right time to consider the role of firms which carry out this activity. We discuss this further in chapter 5.

### Cryptoassets

- 2.33** In January 2021, the Government consulted on its approach to cryptoasset regulation, which proposes to establish a future regime on stablecoins used for payments and includes a call for evidence on investment and wholesale uses of these technologies. Alongside this, in July 2020, the Treasury consulted on the promotion of cryptoassets. The Treasury proposed bringing some cryptoassets into the scope of the financial promotion regime, to enhance consumer protection. The issues discussed in this paper may be relevant to promotions for cryptoassets to the extent they are brought within the scope of the financial promotion regime.

### Special purpose acquisition companies (SPACs)

- 2.34** Special purpose acquisition companies (SPACs) are a subset of 'shell company' that typically raise money from investors by listing and making an initial public offer (IPO) of shares, the proceeds from which are then used to make a future acquisition of another company. Lord Hill's UK Listing Review report published on 3 March 2021 made a recommendation to the FCA to consider changes to our Listing Rules in relation to SPACs, subject to appropriate investor protections.
- 2.35** As we have stated publicly on 31 March 2021, we intend to consult shortly on potential amendments to our Listing Rules and related guidance to strengthen protections for investors in SPACs. We welcome views separately in response to that consultation, although we recognise that financial promotions issues discussed here may also be relevant to SPACs.

### ScamSmart and Investment Harms campaigns

- 2.36** We launched our ScamSmart communication campaign in 2014 to empower consumers with the knowledge and tools to help prevent them falling victim to scams. The campaign focuses on two core objectives—raising consumer awareness of the key warning signs associated with a scam and driving use of our Warning List

tool (which allows consumers to check if a firm is known to be operating without our authorisation). Over 1 million people have visited our ScamSmart website since its launch, and more than 20,000 have been warned directly about specific, unauthorised firms, using the 'FCA Warning List' tool.

- 2.37** We are launching a campaign to help consumers make better-informed investment decisions. The new campaign seeks to address the harm caused from consumers investing in high risk, high return, illiquid investments that are not suitable for their needs. To inform our approach, we undertook research among self-directed investors as described in paragraph 4.6 below. We also ran a digital campaign to warn consumers about the risks of higher return investments, by intervening with our messages when people were looking for investments online. The campaign drove 41,900 people to our website, delivered 2.2m Google adverts (Pay Per Click impressions) and 67,472 Twitter adverts (Twitter ad impressions).

### **The Treasury's consultation on regulation of non-transferable debt securities (NTDS)**

- 2.38** On 19 April 2021, the Treasury published a consultation discussing the case for further regulation relating to the direct-to-market issuance of NTDS. It sets out two policy options for consideration, namely making the issuance of certain types of NTDS a regulated activity and/or extending the scope of the Prospectus Regulation to cover public offers of NTDS. The consultation is open until 12 July 2021, and raises issues which are relevant to this discussion, in particular whether our rules for marketing SISs are sufficient to protect consumers from harm from NTDS, or whether further reforms are required.

## **Equality and diversity considerations**

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- 2.39** We have considered the equality and diversity issues that may arise from the issues in this DP. Overall, we do not consider that any of them would negatively impact any groups with protected characteristics under the Equality Act 2010. Recent research suggests that that newer emerging investors (those investing for less than 3 years) are increasingly likely to be female, younger, more ethnically diverse and more likely to be in a lower socio-economic group, but any changes will apply to all investors in the same way.
- 2.40** We will continue to consider the equality and diversity implications of the ideas during the discussion period and will revisit this in the following consultation. In the meantime, if you have any views on this, please include them in your response.



## 3 Our classification of high-risk investments

### Introduction

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- 3.1** The first step in segmenting the high-risk investment market is to define the types of investments where we think there should be restrictions on making financial promotions to retail investors. We also need to consider what level of restrictions should apply, eg should there be a mass-marketing ban or is some marketing to retail investors appropriate provided there are additional protections?
- 3.2** We discuss what mean by 'high-risk investments' in paragraphs 1.8 and 2.18 to 2.29 above. Consumers will often be unable to tell the difference between different types of investment. So our classification aims to differentiate between those investments which are generally inappropriate for, and do not meet the needs of, most retail investors, those which may be appropriate to a limited extent for some retail investors' needs, and those which are more likely to be generally appropriate. It is important that our classification treats products with similar characteristics in a similar way and minimises opportunities for arbitrage.
- 3.3** This chapter discusses our current classification of investments in COBS 4. We want to know views on two key questions.
- Are there any investments which are not currently subject to marketing restrictions which should be?
  - Should we change how certain types of investments are currently classified under our financial promotion rules, consequently changing the level of restrictions that apply?

### Background

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- 3.4** COBS 4 breaks investments down into 3 main classifications.
- Readily realisable securities (RRSs) – can generally be marketed to retail investors without restrictions under our financial promotion rules
  - Non-readily realisable securities (NRRSs) and P2P agreements – there are restrictions on direct offer financial promotions as described in paragraphs 2.20 to 2.23 above.
  - Non-mainstream pooled investments (NMPIs) and speculative illiquid securities (SISs) – NMPIs and SISs cannot be mass-marketed to retail investors as described in paragraphs 2.24 to 2.28 above.
- 3.5** Our application of restrictions to different types of product has developed over time in response to specific harms. So, it may not capture the full universe of high-risk investments and there may be inconsistencies in how some investments are treated. We discuss this further below.

## Our approach to classification

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- 3.6** The distinction between the classifications reflects a judgement on the characteristics of the investment, including the riskiness of the investment, whether we think a retail investor will be able to understand it, and any other relevant features.
- 3.7** We would generally expect a listed or exchange traded security which is traded on a venue providing liquidity and is subject to initial and ongoing transparency requirements to be more likely to be an appropriate investment for retail investors than an unlisted or non-exchange traded security which does not have these features. So, we generally allow RRSs to be marketed without restriction under our financial promotion rules.
- 3.8** We would also expect a consumer to find it easier to understand what they are investing in where the investment is issued to finance a single business carrying on a commercial activity that has been deliberately chosen by the investor (eg an NRRS), as opposed to where the proceeds are used by the issuer to on-lend or on-invest. So, we consider that this type of investment may be appropriate for the needs of some retail investors, and allow marketing subject to the restrictions we place on direct offer financial promotions. And where there are regulatory or other protections which provide an assurance that a fund or other pooled investment vehicle may be an appropriate investment for retail investors, our rules permit appropriate marketing (for example for authorised funds and investment trusts).
- 3.9** This is in comparison to other types of investment where the proceeds are used to on-lend or on-invest in other businesses, investments or property, frequently with deduction of fees and charges which are often significant. We think these types of investment are generally inappropriate for retail investors because they are complex and difficult to understand, and do not meet most consumers' needs. So, we have put in place a mass-marketing ban for NMPIs and SISs to prevent most retail consumers from being exposed to this type of investment.
- 3.10** As new high-risk investments are identified or when new investments are brought within the scope of the financial promotion regime, we need to consider how we will classify them for the purpose of our financial promotion rules. For example, as explained in chapter 2, the Treasury has proposed bringing some cryptoassets into the scope of the financial promotion regime and we would need to classify them under our financial promotion rules as part of this.
- 3.11** If you think an investment that is not currently subject to any restrictions should be, please give us details, including the evidence of harm to consumers which would justify us restricting its promotion.

## Changes to current classifications

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### Potential arbitrage for speculative investments

- 3.12** The rules for SISs in COBS 4.14 apply to debentures and preference shares which meet the definition of a SIS. In summary, this is where the proceeds of the issue of the debenture or preference share are used to on-lend, buy or acquire investments, or buy or fund the development of property. However, we want to ensure that the harm

that we have seen in relation to speculative mini-bonds does not migrate to other forms of investment with similar speculative features. While legal forms may differ, our focus is clear – we want to ensure that investments which are high risk and difficult for consumers to understand are not marketed to them.

- 3.13** As part of making our rules for SISs permanent, we had already identified a route for arbitrage and extended the mass-marketing ban to cover listed debentures which meet the SIS definition and which are not regularly traded. However, we have identified other possible routes for arbitrage and these are discussed below.

### ***Equity shares***

- 3.14** The SIS rules do not cover shares in companies other than preference shares. So ordinary shares in companies that carry on the activities which are included under the definition of a SIS are not subject to the SIS rules.
- 3.15** We have in the past seen some structures involving ordinary shares issued to raise capital for speculative purposes. To attract retail clients, these shares can be marketed with a focus on an attractive 'target return' and imply that the investment is 'secured' or 'asset-backed.' This makes returns appear more probable and less risky than is the reality, in a similar way to what we saw with speculative mini-bonds.
- 3.16** More generally, ordinary shares could offer an easy arbitrage route for issuers seeking to raise funds for highly risky and opaque activities that are more akin to unregulated collective investment schemes (UCIS) but are structured in a manner that allows such securities to remain outside our definition of an NMPI. At present, shares in special purpose vehicles (SPVs) may be subject to our rules on the marketing of NMPIs in [COBS 4.12](#). We [previously consulted](#) on amendments to define 'pooled investment vehicle' for the purpose of those rules when we became aware that there was difficulty in interpreting the Handbook Glossary definition of 'SPV' in this context, but have not yet made any changes. So in practice, many shares in SPVs continue to be subject to our rules for NRRSs in [COBS 4.7.7R](#) where they do not clearly fall within the scope of our rules on NMPIs.
- 3.17** We think the best way to address our concerns in this area is to include equity shares as a type of security that can be a SIS, alongside debentures and preference shares. So, where equity shares are issued for on-lending, buying or acquiring investments or buying or funding the development of property, they would also be subject to the mass-marketing ban.
- 3.18** However, in line with what we say in paragraph 3.8, where there are regulatory or other protections in place for pooled investment vehicles that provide assurance that they may be appropriate investments for retail investors, we do not intend for them to be subject to a mass-marketing ban. This is reflected in the current definition of an NMPI which excludes shares issued by investment trusts and certain other investment companies, venture capital trusts and real estate investment trusts from being caught by the mass-marketing ban for NMPIs (see the [Handbook Glossary definition of 'excluded security'](#)).
- 3.19** We consider that the aim of bringing relevant equity shares into the scope of the SIS rules is broadly the same as what we were trying to achieve by including securities issued by SPVs within the scope of the NMPI rules, ie to stop the mass-marketing of certain securities where returns depend on an issuer achieving pooled returns from lending to third parties or from other investments or property, usually involving a

high degree of speculation and risk. Consistent with our approach to debentures and preference shares, we think these types of securities are high risk and difficult for consumers to understand. We also think that whether or not the security is issued by an SPV is irrelevant to this assessment – it is the use of proceeds which is key, not the legal structure that is adopted. So if we make this change, we think that we can remove securities issued by an SPV from the definition of an NMPI.

**3.20** Before we consult on this change, we want to hear views on this, in particular whether there might be any unintended consequences, to ensure we get the scope right. We would also like to hear views on the potential impact of making this change, including how many consumers, issuers and securities might be affected, any further evidence of harm in this area and what costs would be incurred by firms and issuers.

**3.21** We are aware that some of the entities that may be brought within the scope of the SIS rules as a result of this change may also fall within the definition of an alternative investment fund (AIF), and be subject to the UK marketing regime for AIFs. We will have regard to this when considering rule changes.

### ***P2P agreements***

**3.22** P2P agreements allow investors to make a financial return from interest payments on, and the repayment of capital under, loans directly to consumers or businesses. P2P agreements are specifically excluded from the SIS rules but are subject to the requirements for direct offer financial promotions in COBS 4.7. There are also specific governance arrangements and a risk management framework for P2P platforms. Broadly, these requirements exist to ensure firms:

- price and value P2P agreements fairly and appropriately
- prevent lenders from being exposed to risk outside of the parameters advertised at the time of investment
- have a reasonable basis to conclude that a target rate of return can be reasonably achieved

**3.23** The rules in COBS 4.7 are intended to ensure that only retail investors capable of understanding the risks and of bearing the consequences invest in P2P agreements. However, P2P platforms can still promote their products to the mass market.

**3.24** While many P2P agreements do not share the features of SISs because the money loaned by the investor is not used for any of the purposes set out in COBS 4.14 (also noting our Dear CEO letter in 2017), where a P2P agreement has similar features to a SIS (for example where it is a loan to a property developer) there is the possibility for arbitrage. In other words, a property developer could still seek retail investment through a P2P platform instead of issuing a mini-bond, and this P2P agreement could still be mass-marketed (subject to the COBS 4.7 rules).

**3.25** We are seeking views on whether (and why) you think the existing requirements for P2P platforms are adequate to protect retail investors from the risks of P2P agreements which share features with SISs. Or should the mass-marketing ban be extended to P2P agreements which have the relevant features of a SIS, and if so, what evidence of harm to consumers is there? We also want to hear about the potential impact of any change in this area, in particular how many consumers and P2P agreements might be affected, and what this change would cost firms and borrowers.

## Other features of investments

- 3.26** Our SIS rules focus on certain uses of proceeds of investments as explained above, namely on-lending, buying or acquiring investments or buying or funding the development of property. These are the types of investments where we had identified the greatest consumer harm, and which we consider are generally not suitable for retail investors because their complex and opaque nature makes them difficult to understand. This was in line with our longer-standing approach to NMPIs.
- 3.27** We are considering whether there are other features of investments that make them generally inappropriate for retail investors' needs, and so should also be subject to a mass-marketing ban. For example, while we use the term 'speculative' to describe the uses of proceeds set out above, investments in a business which has no track record could also be considered 'speculative'. Retail investors may not be best placed to assess the risks of the business establishing itself in its early days. However, we recognise the vital role start-ups play in economic growth and do not want to unnecessarily restrict their access to capital. Existing protections under our NRRS rules, and the ideas discussed in Chapter 4 may be sufficient to protect consumers.
- 3.28** We want to hear if you think there are other features of investments which mean they are generally inappropriate for retail investors and should be subject to a mass-marketing ban. Please provide your reasons, including, where possible, any evidence of harm, how many consumers, issuers and investments might be affected, and what costs would be incurred by firms and issuers if a change is made.

## Readily realisable securities

- 3.29** The RRS definition is intended to identify liquid securities for which there is a reliable market and pricing. On this basis, the definition is used in the financial promotion rules to identify those investments that can be generally promoted to retail investors. As we say above, we would generally expect a listed or exchange traded security which is traded on a venue providing liquidity and is subject to initial and ongoing transparency requirements to be more likely to be appropriate for retail investors than an unlisted or non-exchange traded security. However, these securities still come with a risk that an investor could lose their money. Securities that fall within this RRS definition can generally be mass-marketed to UK retail investors without restrictions in our financial promotion rules.
- 3.30** There are two Handbook Glossary definitions of an RRS. For the purposes of this discussion, we are only concerned with the definition as it applies in the financial promotion rules governing the SIS rules (COBS 4.14) and for the purposes of the NRRS definition. This does not include its application in the Collective Investment Scheme sourcebook (COLL) or the alternative definition used elsewhere in the Handbook.
- 3.31** For the purposes of the financial promotion rules, an RRS is a security which is:
- a.** "a government or public security denominated in the currency of the country of its issuer;
  - b.** any other security which is:
    - i.** admitted to official listing on an exchange in the UK or EEA State; or
    - ii.** regularly traded on or under the rules of such an exchange; or

- iii. regularly traded on or under the rules of a recognised investment exchange or (except in relation to unsolicited real time financial promotions) designated investment exchange;
- c. a newly issued security which can reasonably be expected to fall within (b) when it begins to be traded."

**3.32** The RRS definition's focus on liquidity is by reference to investment exchanges. It includes a broad range of investment exchanges and multilateral trading facilities (MTF) from around the world which have different due diligence requirements, admission standards and are subject to divergent rules and regulations. Our regulatory grip over these exchanges varies and often relies on deference to the relevant national competent authority or indeed the national exchange. The current definition also includes the legacy concept of a designated investment exchanges (DIE), which has been removed from most of the Handbook. The definition of "officially listed" also varies between the UK and certain EEA states, with some EEA states including securities admitted to trading on an exchange-regulated MTF within their definition of official listing. Securities admitted to trading on a UK MTF would not fall under the UK Official List and therefore there is an unacceptable risk of arbitrage by continuing with this approach.

**3.33** We have seen consumer harm arise from securities that fall within the RRS definition, most recently through listed debentures which shared characteristics with speculative mini-bonds (but were exempt from our temporary product intervention for SISs because they were RRSs under limb (b)(i)). In response, we extended the permanent mass-marketing ban for SISs to listed debentures which otherwise meet the definition of a SIS but are not regularly traded. This change was necessary because there is no requirement for listed securities to be regularly traded under limb (b)(i) of the definition, unlike in limbs (b)(ii) and (b)(iii).

**3.34** We no longer consider it appropriate to treat exchanges in EEA Member States in our Handbook differently from exchanges in other third countries, eg the United States, so propose to remove "or EEA State" from our definition of RRS for the purposes of our financial promotion rules. Furthermore, we also propose to remove any fixed income securities traded on an exchange-regulated MTF from the definition. We are also seeking views on how to amend the definition of an RRS in the context of the financial promotion rules, and whether the focus on liquidity by reference to a list of investment exchanges is the right way to distinguish securities which are appropriate for mass-marketing without restrictions to retail investors from those which are not.

**3.35** We want to hear your views on whether there is further harm or potential harm to UK retail investors arising from the mass-marketing of securities which fall within the definition of an RRS. Please provide any evidence of harm.

**3.36** Where there is harm, or the potential for harm, how should we define those securities which continue to be appropriate for mass-marketing to retail investors without restrictions in our financial promotion rules? Should a new definition go beyond a list of exchanges to include a concept of quality, and if so, what features do you think are relevant? And how can we best achieve this in our financial promotion rules, considering the broader primary markets landscape?

- Q2:**
- a. Are there any investments which are not currently subject to marketing restrictions which should be?
  - b. If yes, what is the investment and what level of restriction should apply?
  - c. Please explain your answer, including providing evidence of harm.
- Q3:**
- a. Should there be changes to how certain types of investments are currently classified for the purposes of our financial promotion rules to prevent arbitrage in the context of our SIS rules?
  - b. If yes, what changes are needed?
  - c. Please explain your answer, addressing the issues we identify in paragraphs 3.20 and 3.25 where appropriate.
- Q4:**
- a. Are there any other features of an investment which means they are generally inappropriate for retail investors and should be subject to a mass-marketing ban?
  - b. If yes, what are the features?
  - c. Please explain your answer, addressing the issues we identify in paragraphs 3.26 to 3.28.
- Q5:**
- a. Should we change the scope of securities covered by our RRS definition for the purposes of the financial promotion rules?
  - b. If yes, how should the scope be changed?
  - c. Please explain your answer, addressing the issues we identify in paragraphs 3.29 to 3.36
- Q6:** Please provide any data you have about the potential impact of any changes discussed in chapter 3. For example: the number of consumers, issuers, firms and investments which might be impacted; the potential costs and benefits of any changes.

## 4 Further segmenting the high-risk investments market

### Introduction

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- 4.1** A key theme in responses to the Cfi was the need to further segment high-risk investments from the mainstream market. In chapter 3 we explained that the first step in implementing this segmentation is to define the types of investments where we think there should be restrictions on making financial promotions to retail investors and to consider what level of restrictions should apply.
- 4.2** This chapter looks at what changes we could make to our financial promotion rules to further support and enhance that segmentation of high-risk investments from the mainstream market. Based on responses to the Cfi, we are now focusing on strengthening three areas:
- categorising retail investors (as high net worth, sophisticated or restricted investors) where our rules restrict the communication of financial promotions (or direct offer financial promotions) to retail investors who meet the relevant criteria
  - improving risk warnings to help consumers better understand and engage with them
  - adding 'positive friction' to the consumer journey when making high-risk investments that will lead to more effective decisions
- 4.3** In further segmenting the high-risk investment market, our aim is to improve the ability of consumers to make effective decisions. This will be relevant to all consumers, particularly those who may have characteristics of vulnerability and who may struggle to understand or take in information. As with our finalised [guidance on the fair treatment of vulnerable customers](#), our proposed interventions seek to encourage firms to understand customer needs and take practical action to meet their needs. As customers may process information differently, firms should already ensure their customers do not feel rushed into making decisions and that complex terms and concepts are communicated clearly and in a form that customers can engage with.

### Background

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- 4.4** As described in more detail in chapter 2, there are requirements aimed at ensuring that high-risk investments are only promoted to retail investors for whom they might be appropriate and meet their needs. Despite these rules, we are concerned that too many consumers end up in inappropriate high-risk investments which do not meet their needs by simply 'clicking through' without sufficient understanding of the risks of the investment. We discuss below how our rules could be strengthened to help prevent this.



- 4.5** In considering these issues, we need to balance the benefits of these interventions in preventing consumers investing in inappropriate products which do not meet their needs, against the costs they impose on firms and the impact on firms' business models. We also need to calibrate these interventions so they are effective in influencing consumer behaviour but do not unnecessarily deter consumers from making investments that are appropriate for them. We therefore welcome views on how to get this balance right and how we can most effectively calibrate these interventions.

## BritainThinks research on self-directed investors

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- 4.6** We commissioned BritainThinks to conduct in-depth research on self-directed (ie non-advised) investors. We summarise the research below.
- Self-directed investors appear to be particularly vulnerable to inappropriate high-risk investments. Across most high-risk investment categories, a significant portion of investors either are not aware – or do not believe that – they could lose some or all their money. For example, over four in ten (45%) did not view 'losing some money' as a potential risk of investing. This can partly be explained by current risk warnings which are perceived as white noise to many investors and do not convey the genuine possibility of an investment loss.
  - This set of self-directed investors also seem more likely to jump into higher risk investment types more quickly than more traditional audiences, who typically built up to risk over time. This pattern appears to be driven by newer self-directed investors being attracted by more 'innovative' high-risk, high-return investment types like investment-based crowdfunding and cryptocurrency.
  - These investors do not appear to be matching the risk of their investment with their own risk appetite. Half (51%) of newer self-directed investors who invested in high-risk products score their risk appetite as less than eight (on a zero to ten scale). This indicates they had an average openness to risk. In addition, they do not appear to be able to absorb losses from their risky investments. Nearly two thirds (59%) claim that a significant investment loss would have a fundamental impact on their current or future lifestyle such as household bills and credit commitments becoming a burden.
  - Investment decisions are highly influenced by emotional and social drivers such as gut instinct, novelty and perception of other people's investment success. Four in ten investors (38%) are being driven solely by these types of motivating factors.
- 4.7** This research forms an important backdrop to the issues we discuss below, and we will take the findings into account as we consider how best to strengthen our financial promotion rules to help prevent consumers from making inappropriate investments.

## Strengthening the process for categorising retail investors

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- 4.8** Our rules, discussed in more detail in Chapter 2, requiring investors to be categorised provide an initial layer of protection, by preventing the promotion from being made to an investor where it is unlikely to be appropriate for them and meet their needs. This is either because the investor is unlikely to be able to fully understand the investment, or has a limited ability to absorb losses if the investment fails. They represent a key way in which we already segment high-risk investments from the mainstream investment market.

**4.9** Our financial promotion rules allow promotions (or direct offer financial promotions in the case of NRRSs and P2P agreements) for higher risk investments communicated or approved by an authorised firm to be made to high net worth and sophisticated investors, reflecting the existing exemptions available in the FPO. However, unlike promotions made under the FPO exemptions, promotions made in compliance with our rules are subject to other Handbook requirements, including the general rules applying to financial promotions (eg the fair, clear and not misleading rule) and the rules requiring an appropriateness or preliminary suitability assessment in many cases, in addition to the categorisation process.

**4.10** Our rules also allow for direct offer financial promotions for NRRSs and P2P agreements communicated or approved by an authorised firm to be made to 'restricted investors' as described in chapter 2 above, who do not invest more than 10% of their net assets.

### **Cfl responses – investor categorisation**

**4.11** Respondents to the Cfl questions on direct sales, ie non-advised sales (Q15-18) and high-risk investments (Q19) highlighted the importance of accurate investor categorisation in preventing harm from consumers being exposed to inappropriate products. Many respondents, particularly consumer groups, thought greater responsibility should be placed on firms to ensure better outcomes for consumers. Other respondents, particularly financial advisers, thought more could be done to help consumers understand the implications of how they are categorised. In particular, they said this is important when their categorisation involves them losing regulatory protections.

### **Responsibility of firms to ensure accurate categorisation**

**4.12** To be categorised as a high net worth, sophisticated or (in the case of NRRSs or P2P agreements) restricted investor where a promotion is approved or communicated by an authorised firm, a retail investor must currently provide a signed statement. This makes the required declaration that they meet the relevant conditions to be that type of investor in the format set out in our Handbook. A firm must take reasonable steps to establish that a person to whom a promotion for an NMPI or SIS is made is in the high net worth or sophisticated investor category.

**4.13** Where a firm wishes to rely on an investor being a high net worth investor to make a promotion for an NMPI, COBS 4.12.9G notes that the firm should have regard to its duties under the Principles for Business and the client's best interest rule in COBS 2.1.1R and, in particular, the firm should take reasonable steps to ascertain that the investor does in fact meet the income and net assets criteria. Similarly, COBS 4.12.11G notes that a firm which wishes to rely on the self-certified sophisticated investor exemption for the purpose of the NMPI rules should have regard to those same duties. It then notes that it is unlikely to be appropriate for a firm to make such a promotion without first taking reasonable steps to satisfy itself that the investor does in fact have the requisite experience, knowledge or expertise to understand the risks of the investment in question.

**4.14** Building on the Cfl responses, we are thinking about how to enhance the responsibilities of an authorised firm involved in the categorisation process, and what we should expect in the way of verification. We have previously received feedback that requiring firms to check evidence such as payslips or bank statements could deter potential investors for the wrong reasons, ie because the process would be

too onerous or intrusive. However, given the investor harm we have seen from inappropriate investment where an investor has not understood the risks and/or has suffered losses they cannot afford, we believe that further requirements are needed. The development of Open Banking and Open Finance technologies can also significantly reduce the burden of verification on firms, and so change what can be reasonably expected of firms.

- 4.15** We also note that the effectiveness of any obligations we might introduce will depend to some extent on the involvement of an authorised firm on an ongoing basis. So the issues discussed in chapter 5 around the ongoing obligations of a section 21 approver and in particular how involved they should be in the client categorisation process, are closely linked to this issue and we will take this into account.
- 4.16** There are several changes we could make to strengthen firms' obligations in the categorisation processes. For example, we could require firms:
- to take 'reasonable steps' in all cases to independently verify that a retail investor meets the relevant requirements to be characterised as a high net worth or sophisticated investor, or to verify that restricted investors are not investing more than 10% of their net assets
  - to have grounds to reasonably believe that an investor meets the relevant requirements (and to document those grounds)
  - to have regard to any information that they hold about the relevant individual from other interactions, or collect as part of the appropriateness or preliminary suitability assessment, when considering whether to question a declaration
  - to question or verify declarations where there are certain 'red flags', for example where an investor attempts to invest an amount over a certain threshold
- 4.17** We do not believe that leaving the current situation which relies largely on self-certification is the right outcome, but equally want to ensure that we achieve the right balance between obligations on firms and the regulatory principle that consumers should take responsibility for their own decisions. However, while we have regard to this general principle, we know there are factors that might limit consumers' ability to do so.
- 4.18** We are seeking views to help us get the balance of responsibilities right. In particular, we want to understand the potential costs to firms of these measures and the wider impact on retail investment in high-risk investments if more checks and evidence gathering relating to investor categorisation was required. We also want to understand from firms what they think is practical and reasonable for them to do to get a reasonable assurance that a retail investor meets the relevant requirements.

### Helping consumers better categorise themselves

- 4.19** As explained above, the categorisation of an investor into one of the relevant categories is generally based on the declaration made by the consumer. We think that this potentially leaves scope for consumers to incorrectly categorise themselves, not least because they fail to understand the significance or the consequences of the declaration they are making, particularly where they are just clicking through a series of questions. We will look to investigate the reasons underlying incorrect categorisation and test interventions informed by behavioural science to help retail investors better categorise themselves.

**4.20** From the perspective of the consumer, possible ways of ensuring that they categorise themselves correctly include the following.

- We could introduce a requirement for a clearer and more prominent risk warning at the point an investor makes a declaration about their categorisation, potentially making use of loss framing and highlighting the potential consequences for consumers of that declaration.
- The clearer risk warning could also be designed to directly address social and emotional drivers of investment choice that may induce people to make an incorrect declaration.
- We could also consider other changes to the format of the declaration to require a consumer to make a more active choice, for example:
  - banning the use of pre-ticked tick boxes and reframing passive declaration statements as explicit questions
  - changing the format of the declaration so that an investor needs to provide (eg in a checklist) additional relevant self-declared information as part of the process, eg salary, net assets, amount previously invested in other high-risk investments
  - introducing positive frictions into the declaration process to encourage reflection and more mindful interaction.

**4.21** We are proposing to test some of these suggestions to consider their impact on consumer behaviour.

**4.22** To help us to decide what changes to make in this area, we are seeking views on the potential impact on issuers and firms of these suggested measures, and your views on their potential effectiveness. We would also welcome any other suggestions for changes to ensure investors categorise themselves correctly.

## Improving risk warnings

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### Cfl responses – risk warnings

**4.23** In the Cfl we asked '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?' (Q26). Many respondents to this question expressed doubts about the effectiveness of the current system of risk and regulatory protection disclosures. Respondents felt that consumers did not engage with these warnings and viewed them as 'wallpaper' which were ignored. This led to consumers not fully appreciating the risks of their investments and believing that they would benefit from regulatory protections (such as FSCS coverage) when they would not.

**4.24** There was a consensus among respondents that the problem wasn't the amount of information given to consumers, but the way it was conveyed and whether consumers engaged with the information provided. Most suggestions for improvements therefore focused on the format of disclosures.

**4.25** The most popular idea was that disclosure should be shorter, sharper and written in plain English. Current risk warnings used in financial promotions were viewed as too legalistic and not accessible for the average consumer, leading to disengagement. Respondents highlighted the FCA's ScamSmart campaign as a good example of plain English warnings.

- 4.26** Another popular idea from respondents was for disclosures to focus on visual based warnings. For example, a quality-mark system to show whether an investment is covered by the FSCS, or a traffic light system to illustrate the level of investment risk. Respondents thought these would be more effective at conveying information to consumers.

### **Making risk warnings more effective**

- 4.27** We don't think that disclosure alone can address the challenges that consumers face. However, we do think that there is a role for a clear, prominent and concise risk warning and agree with Cfi respondents that more can be done to help consumers engage with them.
- 4.28** We generally see financial promotions tracking the language in our Handbook guidance and including risk warnings along the lines of 'Your capital is at risk'. However, we agree with Cfi respondents that this type of messaging is unlikely to cut through to consumers and does not disclose the potential investment risks in a way that prompts consumers to reflect on the real-life consequences of a potential loss of net wealth.
- 4.29** The rules we introduced for SISs included requirements for specific and prominent disclosure, including a standardised risk warning, which clearly states that investors could lose all their money, these products are high risk (and riskier than a savings account), and (where relevant) ISA eligibility does not guarantee returns or protect investors from losses. Behavioural experiments run with Warwick Business School tested the relative effect of this risk warning against a 'capital at risk' style warning and the results were published in a [Research Note](#). The results showed that the SIS risk warning improved investors' comprehension of the risks of investing in speculative mini-bonds.
- 4.30** Given the known limitations of 'capital at risk' style warnings, we are interested in hearing views on whether the risk warnings we introduced for SISs should be applied more broadly. In particular, should they be applied to all investments, or just high-risk investments. We need to balance the need to help consumers understand the risk of their investment, against inadvertently causing consumers to view all investments as equally risky and not realising when they have moved from mainstream, diversified products to high-risk investments.
- 4.31** In addition to written risk warnings, we are keen to explore whether visual-based risk warnings could help influence consumer behaviour. For example, whether a visual warning should be applied to all investments subject to a marketing restriction and whether visual warnings could help consumers better understand when they are covered by regulatory protections.
- 4.32** We would need to carefully balance the potential benefits of these ideas from increased transparency and consumer understanding against the risk of oversimplifying what are inherently complex and multifaceted risks. For example, just because an investment is not subject to a marketing restriction does not mean it is 'safe' or that it is not possible for consumers to lose all their money. We would also need to carefully consider the challenges in implementing any visual warnings as regulatory protections, such as FSCS coverage, also depend on how an investment is distributed, not just the investment itself. We welcome views on how we can get this balance right.
- 4.33** To support our work we intend to undertake further experiments to help us understand what changes to written and visual risk warnings, including changing the point at which they are displayed, can be made to address known behavioural drivers and improve consumer understanding for high-risk investments.

## Positive frictions in consumer journeys

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### Cfl responses – positive frictions

**4.34** In the Cfl we asked '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?' (Q19). Many of the responses we received are aligned to ideas discussed elsewhere in this DP. For example, there was strong support for greater restrictions on retail consumers accessing high-risk investments, as discussed in Chapter 3. There was also support for stronger risk warnings, as discussed above.

**4.35** Some respondents also provided interesting thoughts about how the imposition of intentional 'positive' frictions in consumer journeys could improve consumer decision-making, and ensure consumers adequately consider the relative risks and potential rewards before investing in high-risk investments.

### Possible additional frictions

**4.36** Building on the restrictions we already apply to limit access to financial promotions for higher risk investments, we are considering how other 'positive frictions' in the consumer journey in response to a financial promotion communicated or approved by an authorised firm could help further segment high-risk investments from the mass market, as suggested by Cfl respondents.

**4.37** The aim of these frictions would be to prevent consumers from simply 'clicking through' and accessing high-risk investments they do not understand and do not match their risk appetite. Some measures we might consider include:

- introducing deposit collection and investment frictions, such as cooling off periods or requiring SMS confirmations before investments are made
- requiring consumers to watch 'just in time' education videos, eg on investment risks, the benefits of diversification, regulatory protections
- requiring consumers to demonstrate sufficient knowledge about financial products, for example passing an online test

**4.38** As part of our consideration, we intend to test some of these ideas and potentially other ideas informed by behavioural research to help us to understand their effectiveness at influencing consumer behaviour. We are seeking views on the potential impact of these changes, and whether there are any other 'positive frictions' we should consider. We are keen to understand how these changes might impact consumer behaviour and firms' business models, and whether there may be any unintended consequences of these changes.

- Q7:**
- a. Do you think more requirements should be placed on firms to ensure the accurate categorisation of retail clients?**
  - b. If yes, what requirements should be introduced?**
  - c. Please explain your answer, addressing the issues we identify in paragraphs 4.12 to 4.18.**

- Q8:**
- a. Do you think changes should be introduced to help consumers better categorise themselves?
  - b. If yes, what changes should be introduced?
  - c. Please explain your answer.
- Q9:**
- a. Do you think the risk warnings we introduced for SISs should be applied more broadly?
  - b. If yes, what investments should they apply to?
  - c. Please explain your answer, addressing the issues we discuss in paragraphs 4.27 to 4.33.
- Q10:**
- a. Do you think visual based risk warnings should be introduced for high-risk investments?
  - b. If yes, what visual based risk warnings should be introduced?
  - c. Please explain your answer.
- Q11:**
- a. Do you think additional 'positive frictions' should be introduced to the consumer journey for high-risk investments?
  - b. If yes, what changes should be introduced?
  - c. Please explain your answer.
- Q12:** Please provide any data you have about the potential impact of any changes discussed in chapter 4. For example: the number of consumers, issuers, firms and investments which might be impacted; the potential costs and benefits of any changes and evidence of the potential effectiveness of the changes.

## 5 The role of a section 21 approver

### Introduction

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- 5.1** This chapter considers whether we should change the role and responsibilities of a section 21 approver, to improve the quality of approved financial promotions and the consumer outcomes arising from them. Although not explicitly discussed in the Cfl, given the crucial role these firms play in the financial promotion framework and therefore in implementing the ideas proposed in responses, it is important to ensure that our rules remain fit for purpose.
- 5.2** Many of our concerns about the quality of financial promotions in the past have stemmed from promotions approved by authorised firms for unauthorised persons. We are therefore seeking views on what the role of a section 21 approver should look like, particularly in light of the proposed gateway for section 21 approvers which the Treasury has consulted on.

### Background

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- 5.3** For an unauthorised person to communicate a financial promotion, they must first get their promotion approved by an authorised person (or the promotion must be communicated within an FPO exemption). Under the current regulatory framework, authorised persons can generally approve the financial promotions of unauthorised persons.
- 5.4** Firms that choose to carry out approvals must ensure that the promotion meets our financial promotion rules when they approve it, both in terms of the presentation and in substance.
- 5.5** The role of a section 21 approver is key in ensuring that financial promotions meet the standards we expect. We believe that the requirements currently prescribed in our Handbook could go further to ensure that approved financial promotions continue to comply with our requirements on an ongoing basis and help consumers to make effective investment decisions.
- 5.6** With any new obligations, we wish to ensure that the role of a section 21 approver delivers the right outcomes for consumers. But we also don't want the role to be so resource intensive that firms consider approvals to be economically unviable and don't take on the role. We also recognise that these changes could impact firms approving any financial promotion, not just promotions for high-risk investments.



## Proposed gateway for section 21 approvers

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- 5.7** In July 2020 the Treasury published a consultation on the regulatory framework for the approval of financial promotions. This consultation outlined plans to introduce a gateway which firms would have to pass through to be able to approve financial promotions for unauthorised persons.
- 5.8** If introduced, we anticipate that the gateway would improve the quality of approved financial promotions as firms would only be able to make approvals in areas they have been assessed as having the necessary expertise in. Knowing the population of authorised firms that can approve financial promotions for unauthorised persons will also enable us to supervise them more effectively.

## Ongoing obligations for section 21 approvers

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- 5.9** Once a section 21 approver is content that an unauthorised person's financial promotion meets our financial promotions rules, it can approve it for communication. If the approving firm becomes aware that the financial promotion no longer complies with our rules at any time after approval, it must withdraw its approval. We are considering whether we should include more prescriptive requirements in our Handbook for a section 21 approver to actively monitor a financial promotion after approval, so that it is in a better position to assess whether it needs to withdraw its approval at any time.
- 5.10** Specific ongoing monitoring requirements could cover checking the following.
- Whether any amendments which would require the financial promotion to be re-approved have been made to the promotion after approval, meaning it is no longer being lawfully communicated.
  - Whether there have been any changes, including changes in the matters covered by the due diligence which the section 21 approver undertook on the issuer and the investment (taking our non-Handbook guidance for section 21 approvers into account), which may affect whether the promotion continues to be fair, clear and not misleading. This may include the section 21 approver reconsidering (amongst other things) the ongoing commercial viability of the proposition described in the promotion, and whether the advertised headline rates of return continue to be reasonably achievable.
  - Whether the funds raised through the issue of an investment are being used for the purposes described in the financial promotion.
  - Whether any other relevant requirements imposed by our financial promotion rules and any new requirements we introduce, eg additional positive frictions, are being complied with. We discuss ongoing obligations in relation to client categorisation and appropriateness/preliminary suitability assessments in more detail in the next section.
- 5.11** To help inform our proposals we want to hear views on how prescriptive these ongoing obligations should be and what is reasonably practical to expect from section 21 approvers, including in terms of how often checks should be made. We would also be interested to hear views on what the impact of ongoing obligations might be, in particular the cost implications and how many financial promotions might be impacted.

## Involvement in client categorisation and appropriateness/ preliminary suitability assessments

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### NMPIs and SISs

- 5.12** As explained in chapter 2, before a promotion for an NMPI or SIS which is communicated or approved by an authorised person can be made, a retail investor must first be certified as either high net worth or sophisticated. A preliminary assessment of suitability must also be undertaken for certain investors. The Handbook explicitly requires that the 'firm', ie the authorised firm that is communicating or has approved the promotion to which the COBS 4 rules apply, must take reasonable steps to establish that a promotion is only made or directed at those recipients who fall within a relevant category (including a high net worth or sophisticated investor). Where a preliminary suitability assessment is required, the Handbook again requires that it is the 'firm' who must consider whether the NMPI or SIS is likely to be suitable for the relevant investor.
- 5.13** A preliminary suitability assessment is a personalised exercise. The firm must take reasonable steps to acquaint itself with the investor's profile and objectives, to ascertain whether they think the NMPI or SIS is likely to be suitable for them. The section 21 approver should have the expertise to understand whether an investment is likely to be suitable for the investor. Additionally, if it is the section 21 approver carrying out this assessment it reduces the risk of conflicts of interest affecting the assessment.
- 5.14** So there is an expectation in the Handbook that a section 21 approver is heavily involved in the investment process for an NMPI or SIS, and has a responsibility for ensuring the appropriateness of the product for each investor.
- 5.15** These requirements in our Handbook do not apply to unauthorised firms marketing NMPIs and SISs using the FPO exemptions.

### NRRSs and P2P agreements

- 5.16** For NRRSs and P2P agreements, a firm cannot approve a direct offer financial promotion unless a retail recipient of the promotion is a high net worth, sophisticated or 'restricted' investor, and the rules on appropriateness are complied with. There is no explicit expectation that a section 21 approver is actively involved on an investor-by-investor basis in the same way as for NMPIs or SISs.
- 5.17** We understand that the categorisation and appropriateness assessment processes in the NRRS and P2P contexts are generally automated online exercises. This is because the requirements of an appropriateness assessment better lend themselves to questions that can be part of a standardised assessment rather than the more personalised approach for a preliminary suitability assessment. However, it is clearly the role of a section 21 approver to confirm that any automated processes, and the way they will be implemented, comply with our rules before they approve the direct offer financial promotion.
- 5.18** Where an intermediary such as a crowdfunding platform is marketing the NRRS, there will be a regulated entity responsible for undertaking the categorisation and appropriateness assessment process for each investor. Although the authorised firm in these circumstances will not necessarily be playing an active role in every case where the process is automated, there is still someone bound by our rules responsible for these processes in each individual case. However, in cases of direct sales of NRRSs by an unauthorised issuer under our current

rules, the section 21 approver will have only confirmed compliance with the rules at the point of approval of the promotion, rather than there being a regulated entity bound by our rules applying the processes in every case.

- 5.19** It may be impractical for section 21 approvers to be involved in every case where the processes are automated, and so assessing those processes is potentially more appropriate. However, we do not think this should be limited to a one-off assessment prior to approval. So we think there is a case for introducing a requirement on section 21 approvers to check that the relevant automated processes comply and are being applied in accordance with our rules on an ongoing basis.
- 5.20** We are seeking views on how involved you think a section 21 approver should be in these matters on an ongoing basis, taking into account the practicalities discussed above. We are also interested to hear views on the cost implications of any changes in this area.
- 5.21** In chapter 4, we discuss what requirements should be in place to ensure that investors are categorised correctly, and this includes a role for the authorised firm communicating or approving the financial promotion. So the effectiveness of any obligations on an authorised firm to ensure investors are being categorised correctly where a financial promotion has been approved by a section 21 approver will depend to some extent on how involved the section 21 approver is required to be in the categorisation process on an ongoing basis. We will take this into account when considering this issue.

- Q13:**
- a. **Do you think new ongoing monitoring obligations should be introduced for section 21 approvers?**
  - b. **If yes, what ongoing monitoring obligations should be introduced?**
  - c. **Please explain your answer, addressing the issues we identify in paragraphs 5.9 to 5.11.**
- Q14:**
- a. **Do you think changes should be introduced to the role a section 21 approver in the client categorisation, appropriateness and pre-liminary suitability assessment processes?**
  - b. **If yes, what changes should be introduced?**
  - c. **Please explain your answer, addressing the issues we identify in paragraph 5.20.**
- Q15:** **Please provide any data you have about the potential impact of any changes discussed in chapter 5. For example: the number of consumers, issuers and investments which might be impacted; the potential costs and benefits of any changes.**
- Q16:** **Do you have any other comments you would like to make on the topics covered in this Discussion Paper?**

## Annex 1

### Questions in this paper

- Q1:** Please provide any data related to:
- a. the number of consumers who currently hold high-risk investments, the amount they hold and the type of high-risk investments they hold
  - b. the number of issuers of high-risk investments, the amount they issue and the type of high-risk investments they issue
- Q2:**
- a. Are there any investments which are not currently subject to marketing restrictions which should be?
  - b. If yes, what is the investment and what level of restriction should apply?
  - c. Please explain your answer, including providing evidence of harm.
- Q3:**
- a. Should there be changes to how certain types of investments are currently classified for the purposes of our financial promotion rules to prevent arbitrage in the context of our SIS rules?
  - b. If yes, what changes are needed?
  - c. Please explain your answer, addressing the issues we identify in paragraphs 3.20 to 3.25 where appropriate.
- Q4:**
- a. Are there any other features of an investment which means they are generally inappropriate for retail investors and should be subject to a mass-marketing ban?
  - b. If yes, what are the features?
  - c. Please explain your answer, addressing the issues we identify in paragraphs 3.26 to 3.28.

- Q5:**
- a. Should we change the scope of securities covered by our RRS definition for the purposes of the financial promotion rules?
  - b. If yes, how should the scope be changed?
  - c. Please explain your answer, addressing the issues we identify in paragraphs 3.29 to 3.36.
- Q6:** Please provide any data you have about the potential impact of any changes discussed in chapter 3. For example: the number of consumers, issuers, firms and investments which might be impacted; the potential costs and benefits of any changes.
- Q7:**
- a. Do you think more requirements should be placed on firms to ensure the accurate categorisation of retail clients?
  - b. If yes, what requirements should be introduced?
  - c. Please explain your answer, addressing the issues we identify in paragraphs 4.12 to 4.18.
- Q8:**
- a. Do you think changes should be introduced to help consumers better categorise themselves?
  - b. If yes, what changes should be introduced?
  - c. Please explain your answer.
- Q9:**
- a. Do you think the risk warnings we introduced for SISs should be applied more broadly?
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- a. Do you think visual based risk warnings should be introduced for high-risk investments?
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- a. Do you think additional 'positive frictions' should be introduced to the consumer journey for high-risk investments?
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- Q15:** Please provide any data you have about the potential impact of any changes discussed in chapter 5. For example: the number of consumers, issuers and investments which might be impacted; the potential costs and benefits of any changes.
- Q16:** Do you have any other comments you would like to make on the topics covered in this Discussion Paper?

## Annex 2

### Abbreviations used in this paper

Abbreviation	Description
<b>Cfi</b>	Call for Input
<b>COBS</b>	Conduct of Business Sourcebook
<b>DP</b>	Discussion Paper
<b>EEA</b>	European Economic Area
<b>FCA</b>	Financial Conduct Authority
<b>FSCS</b>	Financial Services Compensation Scheme
<b>HMT</b>	Her Majesty's Treasury
<b>IBCF</b>	Investment Based Crowdfunding
<b>ISA</b>	Individual Savings Account
<b>MTF</b>	Multilateral Trading Facility
<b>NMPI</b>	Non-Mainstream Pooled Investment
<b>NRRS</b>	Non-Readily Realisable Security
<b>NTDS</b>	Non-Transferable Debt Security
<b>P2P</b>	Peer to Peer
<b>RRS</b>	Readily Realisable Security
<b>SIS</b>	Speculative Illiquid Security
<b>SPAC</b>	Special Purpose Acquisition Company
<b>UCIS</b>	Unregulated Collective Investment Scheme

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