Irish Financial Services
Regulatory Authority

Review of the Marketing & Sale of Trackers

March 2004

CONSULTATION PAPER CP3

Table Of Contents

1.	Background	2
2	Areas of concern or possible risk	
	Costs and charges	3
	Disclosure	4
	Documents issued to clients	7
	Projections and past performance	8
	Taxation treatment	9
	Geared trackers	9
	Complexity	10
3.	Consultation process.	11

Tracker Bonds (‘Trackers’) or similar investments

What are Trackers?

Trackers are investments, which promise a financial return of a specified per cent of the original capital (amount of cash invested at the beginning) at the end of a chosen term. They also give a cash bonus of a specified per cent of the rise, if any, in a particular stock-market index, indices or basket of stocks. They ‘track’ the chosen basket of indices or stocks and the bonus reflects how well that basket has performed.

Background

Trackers have been sold on the Irish market for the last 12 years. In the early days, life-assurance companies sold them as a form of single-premium (lump-sum) investments. More recently, stockbrokers, banks and investment firms have also offered Trackers. Trackers have developed and become more sophisticated and consumers can sometimes find them complicated and difficult to understand.

In the Irish Financial Services Regulatory Authority (IFSRA – the financial services regulator) we have received queries and complaints about the complexity and possibly misleading nature of some of these products. We reviewed the complaints and examined the products involved and we are now considering developing a Code of Conduct in relation to the advertising and marketing of Trackers.

In view of this, we invite anyone who is interested to make a submission to us about the possible content of such a code. We have identified seven (A to G) main areas of concern and possible risks and 20 issues within those areas. These are set out below, and we ask that your submissions should address these 20 issues.

We would also appreciate any other comments you would like to make about this matter. Please note that we intend to publish all submissions and make them available to the public.

Areas of concern or possible risk

A. Costs and charges

We believe this is an area for concern

All Trackers incorporate costs and charges. These costs are an important issue for consumers when making investment decisions. We believe that all costs and charges should be fully disclosed to provide an open and transparent market in Trackers. The particular elements of costs and charges of most concern are detailed below:

Commissions, fees or charges paid – they are all part of the cost

Tracker commissions, fees and charges are made up in different ways and they all contribute to the overall cost of the Tracker. We view any rebate or refund paid to the product-producer by anyone, whether related or not, as being part of the overall cost of the product and accordingly a cost which should be disclosed to an investor.

'Lock-in' facilities – the consequences should be made clear at the outset

Some tracker bonds have a 'lock-in' facility. This means that any gains made in the early years of the investment are protected against later declines in market conditions. However, these lock-in facilities tend to be complex and may affect investment return. We believe that where lock-in provisions are included in the investment contract, they must be explained and any associated costs fully documented at the beginning of the contract.

What is your view?

We would like your submissions on the following areas

1. Fees paid

Please consider how fees are paid or received and let us know what their effect is on the value of the investment both initially and ongoing.

2. 'Lock-in' provisions

We propose that 'lock-in' provisions on Trackers are clearly disclosed in product documents. Please tell us what you think is the best way to implement such disclosures.

B. Disclosure[1]

Tracker pitfalls – we believe some documents do not highlight the risk

Trackers are complex products and in some cases the documents do not make it clear to the consumer what are the pitfalls of investing in these products. As more and more Trackers are sold to consumers as a safe alternative to deposits, investors need to be informed about these issues. We are most concerned about the following areas.

Dividends and interest – they should be clearly disclosed

When investing in a Tracker part of the proceeds may be used to purchase stocks on which dividends are payable; while another part of the investment may be placed in an interest-bearing deposit account. The beneficiaries of these dividends and interest income and the effects that they have on the investment return are generally not clearly identified in Tracker documents. We believe that these are critical elements which should be clearly disclosed to help investors to make an informed decision.

Death-benefit provisions – these can be misleading

Most Trackers issued by life-companies are attached to a life policy that provides a specific benefit in the event of death of the investor prior to the maturity of the investment. The details of this benefit are normally given in the terms and conditions of the Tracker. Trackers issued by other providers may include a death benefit linked to the value of the fund. This benefit is not always equal to the original capital sum invested.

We believe that the treatment of the investment in the event of death of the investor during the period of investment should be clearly indicated in product documents. Any costs associated with providing death benefit should be clearly disclosed.

Capital guarantees – the value of the guarantee should be fully explained

Guarantees on the initial capital invested can vary. Some Trackers provide 100% guarantee and offer a particular investment return, while others provide a lower percentage capital guarantee but promote a higher anticipated return.

Our advertising requirements are set out in the Handbook for investment firms and they require that where a product, or some aspect of it, is referred to as guaranteed, there must be a legally enforceable guarantee provided by a third party[2].

[1] It is acknowledged that Life assurance companies as required under the Life Assurance (Provision of Information) Regulations, 2001 are already obligated to provide a level of disclosure.

[2] Provision 2 of the Advertising Requirements for investment firms states that 'The Advertisement must not describe an investment as guaranteed or partially guaranteed unless:

(a) there is a legally enforceable agreement with a third party who undertakes
  (i) in the case of a full guarantee to meet, in full, an investor's claim under the guarantee, or
  (ii) in the case of a partial guarantee to meet, to whatever extent is stated in the advertisement, the investor's claim under the guarantee;

and

(b) the advertisement gives details about both the guarantor and guarantee sufficient for an investor to a fair assessment about the value of the guarantee;

and

(c) where it is the case, the advertisement states that the guarantee is from a firm within the same group as the firm.'

At the moment, these particular provisions do not apply to all providers of Trackers, but we are considering including them in the proposed Code of Conduct for Trackers.
In addition, even though the initial capital is guaranteed the guarantee does not protect against the effects of inflation. This factor should be highlighted alongside the reference to a guarantee being provided.

Third parties – they should be disclosed in product documents

Most if not all Trackers, use a third party to underwrite the underlying option in relation to the chosen indices or stocks used in the various schemes. The identities of these third parties are not generally disclosed to the investor.

We believe that these third parties should be identified in the product documentation together with details of the implications of any increased cost for the investor in the event of a third party failing to meet their obligations.

Early encashment penalties – Trackers are not suitable for a regular income

Most Trackers do not provide for early or partial encashment. Where this option is provided for, the investor generally incurs a penalty in the form of a significant loss of capital and/or income. For this reason, trackers are not suitable for providing a regular income.

This is an important issue for the consumer particularly where the investment has been promoted as an alternative to a deposit account. We believe this information should be clearly highlighted in any promotional documents or advertisements.

Currency exchange risk – it must be clear that this can effect performance

Many Trackers invest in a broad range of equities in different markets. Changes in currency exchange rates can have a major impact on investment returns. We believe that where investment takes place in a non-euro zone jurisdiction (for example the US, UK or Switzerland), the dangers posed by fluctuating exchange rates should be clearly outlined in documentation. If the contract provides for insuring (hedging) against exchange-rate volatility the costs involved should be disclosed.

'Averaging' – the pros and cons should both be made plain

Where the Tracker is invested in stock-market-related entities like indices or baskets of stocks, it will be subject to the fluctuations of the stock market. Some Trackers offer a facility to help smooth out these fluctuations. This facility is called averaging.

With averaging the performance of the Tracker reflects the average value of the index or indices or the price of each share in a basket over a given period, for example 6-12 months, rather than at a single date. Documents tend to highlight how averaging can work to the advantage of the investor in a falling market, but rarely highlight that the opposite will apply in a rising market.

What is your view?

We would like your submissions on the following areas

3. Dividends and interest income

How should the treatment of dividends and interest income be disclosed in Tracker documents to ensure that investors are informed about how they will affect the returns they may earn on the Tracker?

4. Disclosure of death-benefit provisions

What are your views in relation to the disclosure of death-benefit provisions in Tracker documents? How should the costs associated with the provision of this benefit be disclosed to investors to ensure clarity?

5. Reference to guarantees

Should the requirements about references to guarantees in advertising that currently apply to investment firms, be applied to all providers of Trackers? If the guarantee is partial, should any additional or more prominent disclosures be made? How should the impact of early encashment (if permitted) on the guarantee be disclosed?

6. Third parties

How should disclosures about third parties be made in product documents?

7. Front page of Tracker document

What do you think about our proposal to include this statement on the front page of any documents issued to promote Trackers: "This investment cannot be encashed prior to the expiry of the period of the investment instrument" where this is the case?

When early or partial encashment is allowed we propose that details of any penalties that apply to such encashments should be provided. These should set out the actual penalties or the method for calculating these penalties.

8. Suitability of investment

We also propose that Tracker documents should clearly state that the investment is not suitable for the provision of a regular income.

9. Currency risk

How should currency exchange risk be disclosed to consumers?

10. 'Averaging'

What do you think about our proposal that where 'averaging' is provided for, it should be fully disclosed how rising and falling markets will affect the investment? Details of any costs involved should also be fully revealed in product documents.

C. Documents issued to clients

Tracker Bond certificates – we don't think they give enough information
In some instances clients may only receive a certificate detailing:

- that their investment has taken place at a specific date;
- that it will mature at a specific future date;
- the name and address of the investor; and
- what party will hold the investment for the specified period.

Clients wishing to clarify full details of their investment must refer back to the brochure provided to them at the time of sale.

What is your view?
We would like your submissions on the following areas

11. Standard note

Should a standard contract note or confirmation be specified for Trackers which must be provided to any consumer investing in such a product?

12. Full set of terms

Should a requirement be introduced specifying that a full set of all terms and conditions be issued to consumers when they invest in a Tracker?

D Projections and past performance

‘Back testing’ – we think information can be confusing

In promoting a Tracker, some brochures place great emphasis on how well they expect a product to perform while others focus on past performance. Another method used to promote Trackers is ‘back testing’. This is a table in the brochure that shows the performance that would have arisen if the product had existed in the past. All of this can be very confusing and does not provide any real idea of the financial return.

What is your view?

We would like your submissions on the following areas

13. Information about growth and return

How might information about projected growth or return on Trackers be presented to give a useful indication as to the probability of a particular return being achieved?

14. Should ‘back-testing’ be prohibited

Would it be appropriate to prohibit the use of ‘back testing’ in Tracker promotions?

15 ‘Health warnings’

How should ‘health warnings’ about past and projected performance be made?

E. Taxation treatment

Tax information – we are concerned that not enough information is given

There are differences in the tax treatment of bank-deposit Trackers compared with insurance-company Trackers. Therefore consumers should be aware that these differences need to be taken into account before investing in these products.

What is your view?

We would like your submissions on the following areas

16. Highlighting taxation

How should product documents make consumers aware that there are different taxation implications when investing in different types of Trackers?

17. How should consumers be told about particular tax implications?

If there are particular taxation implications specific to particular types of Trackers, how should these be brought to the attention of consumers?

F. 'Geared Trackers'

'Geared Trackers' – we believe they are not suitable for most consumers

We have already issued a statement on 'Geared Trackers' highlighting the particular risks associated with this type of product. This product is not suitable for many consumers and it is imperative that any marketing takes this into account.

What is your view?

We would like your submissions on the following areas

18. Specific restrictions

Should there be restrictions on the marketing of 'Geared Trackers'? If so, what restrictions would be appropriate? If not how can inappropriate targeting be addressed?

19. Disclosures about 'Geared Trackers'

What types of disclosures should be made about 'Geared Trackers'?

G. Complexity

Sellers and buyers – we believe they should both be fully informed

Trackers are complex products so it is important that both the sellers and buyers of Trackers are fully informed about the type of Tracker being marketed. Investors should be made aware of the risks of investing in a Tracker. Where the product is sold through an intermediary, it is important that the intermediary is fully informed about the product so that they can give their clients appropriate advice.

What is your view?

We would like your submissions on the following areas

20. Signing a declaration

Should the vendor and the investor be required to sign a declaration in which:

- the vendor confirms that they provided all the documentation relating to the product before the consumer purchased the product?

and

- the purchaser confirms that he/she has received a copy of all the documentation?

The Consultation Process

The closing date for submissions is 21 May 2004.

Comments are welcome from all interested parties. Submissions should be in writing and should also, if practical, be provided in electronic format by e-mail or on disc.

To facilitate the efficient handling of submissions, respondents are asked to use a standard format.

When addressing any issue raised in this paper the corresponding paragraph numbers in the paper should be used to identify the section being referred to. Where the issue being raised is not included in the paper please indicate this in your submission.

We place a high value on the transparency of the consultation process.

Consequently, it is our intention to make submissions publicly available on our website after the deadline for the receipt of submissions has been reached. Parties are advised not to include commercially sensitive material in submissions. Where a party making a submission considers it essential to include commercially sensitive material, such material should be clearly highlighted. Where parties reasonably represent material contained in submissions to be commercially sensitive, we will take such steps as we consider reasonable to avoid publication of that material. To this end, we will endeavor to publish submissions with the relevant sensitive material deleted. Deletions will be indicated.

Notwithstanding the approach outlined in the paragraph above, we will make no representations to the effect that material which a party making a submission considers confidential will not be published and all parties making submissions do so on the basis that they consent to the publications of their submissions in full.

All submissions should be sent:

By post to: Consumer Protection Codes Department
Irish Financial Services Regulatory Authority
P.O. Box 9138
College Green
Dublin 2

By e-mail to trackerscode@ifsra.ie
By Fax to 01 6710659
All submissions should be clearly marked “Trackers submission”

Consumer Protection Codes Department
22 March 2004

Údarás Rialála Seirbhísí
Airgeadais na hÉireann

Please clearly mark your submission '**Trackers submission**' and send it to:

Consumer Protection Codes Department
Irish Financial Services Regulatory Authority
PO Box 9138
College Green
Dublin 2
Email: trackerscode@ifsra.ie
Fax: (01) 6710659