CLARUS
INVESTMENT SOLUTIONS

Review of Consumer Protection Code

Submission to Central Bank of Ireland

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Clarus Investment Solutions is regulated by the Central Bank of Ireland

Introduction

Clarus Investment Solutions ("Clarus") is a specialist investment consulting firm set up in early 2008. It is a partnership between Joseph Mottley and Paul McCarville who are very experienced investment professionals. Both of the principals operated at a senior level in the asset management business in Ireland for over 20 years. That experience encompassed product development, the drafting of product literature and promotion of the company and its products to intermediaries.

Clarus is regulated by the Central Bank of Ireland (Authorised Advisor status). The bulk of our business is with other regulated entities, most of whom seek assistance in the area of investment portfolio design and product/provider diligence. Our clients include MiFID firms, other Authorised Advisers and a number of Multi Agency Intermediaries.

Our core business involves us in continuous reference to fund fact-sheets/brochures, accessing and assessing performance data and in particular the use of provider (typically life company) websites.

As such we are very often in the position of a consumer, albeit a sophisticated one.

For the purpose of assisting the process of compiling the responses we have set out later our answers to the specific questions posed in the Discussion Document– we have limited ourselves to those areas with which we have substantial familiarity.

Observations on Scope

The Code as presently framed and the changes set out in the Discussion Document are very much in the context of 'point of sale' delivery, via an intermediary or sales person.

In our view a broader perspective would better serve consumers.

We say this for a two main reasons:

- Increasing numbers of consumers buy on an 'execution-only' basis and essentially make their choice having searched the available literature, typically using the internet

- Before framing their advice, many intermediaries will narrow down potential fund options by reference to the general information made available by providers, (often via websites) frequently supplemented by data services such as *MoneyMate* or *Financial Express*.

Imposing the obligation to provide detailed information on charges at point of sale but not before appears inimical to the better interests of consumers. The compulsion of petrol retailers to display prices undoubtedly serves consumers far better than had they to wait until pump-side; while financial services are more complex we are convinced that the same principle should hold.

A further area in which the Code and Discussion Document do not do full justice to consumers of investment products is what happens post purchase. Consumers of investment products should be enabled to assess whether their provider is doing a reasonable job by having provided to them performance data **alongside a specified and appropriate benchmark**. There should be an obligation on providers to a) document and b) disclose any changes to the performance benchmark being used.

In our view providers should also be obliged to publicise (if not necessarily notify each investor) material changes in how the fund is managed. Examples of such changes in recent years have been the transition of assets from the management of teams in Ireland to those in other jurisdictions.

Experience of Provider Information

In our extensive experience of researching investment fund literature, especially that available from providers' websites, the standard comes quite a long way short of what would properly serve consumers under the above headings. All too often information we seek (and which we believe it reasonable to expect to find) is either not provided, out of date, inaccurate or incomplete. Where up-to-date, accurate information is provided it still rarely if ever includes information in relation to charges, and more often than not fails to quote performance against an appropriate benchmark.

In relation to the former, we suggest that not alone should all fund literature state what the management charges are (or the range thereof as will tend to be the case in reality),but the disclosure of the fund's Total Expense Ratio (a standard measure of comparison in a number of jurisdictions) should be mandatory. The basis for same should be specified by the Central Bank. Failing to state the Total Expense Ratio (or stating it incorrectly) should result in sanctions on providers.

In our opinion, all literature in respect of investment products (other than structured products or 'with profit' funds) should state what the performance benchmark is. **No performance data should appear unless alongside that of the benchmark.** The Central Bank should specify the basis on which the fund performance is presented - Gross/Net of fees, or where Net and more than one series of a fund, which charge to use.

The other most obvious deficiency in the information provided in respect of funds relates to risk. This issue is dealt with in the Discussion Document - see response later. We believe that detail of

the historical volatility (defined by the CB) should appear on any product literature which includes multi-year performance data.

The Concept of Suitability

We have responded in a later section to the specific questions posed but would wish to highlight a very significant issue which we believe needs clarification.

For many consumers the best and most appropriate solution will be a blend of funds (if for no other reason than diversifying counterparty risk).The use of a range of funds/assets with different risk characteristics and which together improve the relationship between risk and return is the basis of modern portfolio theory. Despite the word 'modern' the bedrock of portfolio theory was pioneered by Harry Markowitz in the 1950s and is still central to financial markets.

We believe absolutely in the idea of funds being risk rated and that these ratings should inform advice to consumers. However a slavish use of ratings (eg. 'client rated at "3", therefore only use funds rated "3" or less') would deprive consumers of the right to the most efficient portfolios (in terms of risk/reward). By way of a current example, a client with a risk rating of "3" on a scale from 1-7 but who requires an income of anything over 1%, will be forced to accept a loss of capital given the net rates of return available on most of the funds rated at or below "3". This is despite their potentially having a sufficiently long time horizon to embrace an element of relatively un-correlated, higher risk funds.

There is currently a degree of confusion in the minds of some intermediaries as regards suitability, caused in part by rulings of the Financial Services Ombudsman.

Proposal to Restrict Definition of 'Advisor'

A consumer might reasonably assume that the term 'advice' in relation to financial products has the same general meaning as applies to other professional services. To most people, the word 'advice' connotes an unbiased assessment of at least a number of possible courses of action. Why should financial services bend the everyday understanding of language? Allowing people who can only recommend the products of one company to be called 'advisors' is in our view an abuse of that term.

We propose that this misleading practice be banned. Specifically, in the area of investment product, we suggest that use of the term 'advisor' be restricted to intermediaries who fulfil the definition of 'broker' as set out in **Chapter 4, Provision 24** of the Draft Code.

Answers to Specific Questions

Q 1 & 2 *Vulnerable Consumers*

While absolutely in agreement that some consumers are significantly more susceptible to mis-selling, the term 'vulnerable' would seem pejorative. Unfortunately we live in a litigious world and a large number of cases end up with the FSO – **who would not like to be described as 'vulnerable' when propagating a complaint (whether well-founded or not)?**

It strikes us (and we have done some work in the mis-selling area) that any regulated entity of significance will now be extremely conscious **of its vulnerability** in terms of complaints from the elderly and others who would be considered less well equipped to understand the transaction. Those entities will be taking steps to protect themselves and which will also protect the (vulnerable) consumer e.g. insisting that an elderly consumer is accompanied to meetings by a relative.

Rather than specifying a substantial additional set of systems and procedures for a (potentially numerous) sub-set of consumers, why not refine 'best practice' in terms of KYC/suitability and apply that to everyone? Most, if not all, of what is set out strikes us as representing very good practice. In particular we cannot imagine why assessing the consumer's attitude to risk should not apply to all consumers.

While very sympathetic to the objective of protecting 'vulnerable' consumers we have an over-arching concern that imposing additional requirements which are too prescriptive or inflexible on a sub-set of consumers may result in:

- regulated entities being less willing to deal with that sub-set
- the price of advice to those people rising significantly
- an excessive conservatism in recommendations

<u>The latter is our main concern</u>, especially as it might affect incomes in retirement; someone retiring at 60 and seeking advice about an ARF may be in perfect possession of his/her faculties and have a life expectancy of close to 20 years. That person will be taxed on a 'deemed withdrawal 'of 5% and may need income at that or a higher level. A very conservative investment strategy informed by the broker's fear of breaching the Code and/or litigation will almost certainly result in a far quicker depletion of the ARF and potentially penury in later life. We are sure that this is not what is intended but **it could easily become an unintended consequence**. Very considerable thought and

consideration needs to be put in to any systems and procedures which are adopted for a sub-set of consumers, particularly where defined by reference to age.

Q 3 - 4 *Suitability of Mortgages* …….no comments

Q 5 - 9 *Information about Products*:-

Q 5

In so far as it applies to investment products the information outlined would be very helpful. Additional information for each fund should include:

- the investment objective
- a specific benchmark for performance
- the Total Expense Ratio
- performance over 1/3/5/7 years and since inception alongside that of the specified benchmark
- historical volatility statistics
- maximum drawdown
- a risk rating

As far as possible the CB should be specific in terms of definition/computation methodology.

Q 6

Yes, a 'Key Facts' document would be a welcome addition, particularly if incorporating the information listed in our answer to Q5.

Q 7…..no comments

Q 8

Where investment products are concerned, a standardised risk rating system (preferably 1-7) would be a good basis for conveying risk. This would be all the more so if the method of risk categorisation had an objective basis such as volatility or a combination of volatility and maximum drawdown. In the case of new funds providers should be entitled to use representative market indices as a proxy for historical performance.

In the case of products underpinned by derivatives or 'with profits' funds providers should be entitled to position the product where they believe appropriate on the same 1-7 scale, but only having taken account of:

- strictures on liquidity /duration
- the opportunity cost associated with a full or partial return of capital
- any counterparty risks being passed through to investors
- the risk of becoming 'cash-locked' in the case of CPPI-based structures
- in the case of 'with profit' funds, the possibility of a market value adjustment

Q 9

We do not favour a traffic light system on the basis that three graduations are insufficient to express and differentiate risk in the spectrum of investment products.

Our preference is to make a scale of 1-7 the standard basis for conveying the risk of investment products.

Q 10 *PRSA* ……..no comment

<u>Q 11 – 14</u> *<u>Product Suitability</u>*:-

Q 11 - 12

The criteria set out in **Chapter 4, Provision 32** would certainly be helpful in identifying the target market for which a given product should be suitable. In the case of investment products we would look to see the items mentioned in our answer to Q5 utilised as well.

However we believe that the crucial basis for defining a target market should be the same as for any product (financial or otherwise) - in the first instance it should be determined by reference to what need is it satisfying. In the case of investment products the need to be satisfied may be less than fully clear-cut, though it may be easier in the case of funds with 'cash plus' target returns.

As a relevant example of how a target market might be defined by reference to consumer need, there is a growing need for products which can produce an income - products designed to fulfil that need should expressly say that such consumers are the target market. Many of these consumers may well be risk averse and there will be a tension between delivering the desired level of income and risk (defined as short-term volatility).

This is a very important point – where a consumer makes it clear that he/she needs income (a financial priority determined as part of KYC) an advisor should not be afraid to recommend a product targeted at generating income just because the risk rating is above the level ascribed to the consumer. {Obviously a lot of information would need to be provided and the situation properly documented}. Clearly the advisor would take account of the risk rating but it should not be 'sacrosanct' especially when incompatible with a financial priority.

Q 13

Agree. Annual.

Q 14

Agree. We do not envisage hurdles to implementation.

Q 15 *Termination of Appointments*

Agree.

Q 16 - 27 …. no comments

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