Financial Services Authority

Fair, clear and not misleading – review of the quality of financial promotions in the structured investments products marketplace

October 2009

Overview

In this report[1], we summarise the findings of our review into the financial promotions of structured investment products. We also provide examples that we found of good and poor practice.

We reviewed the financial promotions of 56 structured investment products, 43 of which were produced in the second quarter of 2009.We found that many of the financial promotions had failings and, in particular, could have described the key risks more fully and effectively.

We are taking appropriate regulatory action for these failings with the firms concerned.

Financial promotions for structured investment products must:

- be clear about where consumers' money is invested, which may include explaining that it is not invested in an index but is loaned to a single financial company;
- clearly explain any relevant counterparty risk;
- prominently state that capital is at risk (if that is the case);
- use language that the target audience is likely to understand; and
- not describe a product as 'protected' or 'guaranteed' if this is an inaccurate or misleading description.

We have produced a good and poor practice guide, containing the above points, which can be found at the end of the report.

1 This report consists of supporting material, the status of which is explained at: http://www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2009/guidance.shtml

Regulatory action

We are taking a range of regulatory actions and we will not hesitate to refer the worst cases to our Enforcement division. We are following up on the firms in our review and will continue to monitor the wider market.

Firms producing financial promotions for structured investment products should take account of our findings and commentary below, and our summary Good and Poor Practice Guide. This material is on our website.[2]

Our review

The over-arching requirement for financial promotions is that they should be fair, clear and not misleading.[3] Our rules require that information provided to retail customers must be sufficient and presented in a way that is likely to be understood by the target audience or likely recipient.[4] Promotions must also be accurate and not emphasise any potential benefits of an investment without also giving a fair and prominent indication of any relevant risks.[5]

We conducted a review of the financial promotions of structured investment products that were not backed by firms within the Lehman Brothers group (Lehman). Our primary aim was to assess the extent to which current practice was fair, clear and not misleading. A secondary aim was to compare current practice with literature from the period immediately preceding Lehman's collapse.

Our assessment excluded structured deposits as these are a different type of product: consumers' money is placed on deposit, instead of being used to buy a debt security and/or derivative.

Of the 56 financial promotions that we assessed, 13 were for structured investment products offered between June and September 2008. This covers the period between Standard and Poor's downgrade of Lehman credit rating and Lehman's petition for Chapter 11 bankruptcy. It captures 12% of the structured investment products that we found to be available to retail investors in that period.

The other 43 promotions were for structured investment products offered between March and May 2009, capturing 39% of the structured investment products that we found to be available to retail investors in that period.

We reviewed the financial promotions before and after the collapse of Lehman to help us establish whether this led to any improvements in financial

2 http://www.fsa.gov.uk/Pages/Doing/Regulated/Promo/index.shtml

3 Principle 7 and COBS 4.2.1 R

4 COBS 4.5.2 R (3)

5 COBS 4.5.2 R (2)

promotions. We found that there had been marginal improvements: more promotions named the counterparty, descriptions of counterparty risk were likely to be more understandable, and the counterparty risk was more likely to be described prominently. However, certain shortcomings remained.

In order to have a fair view of the market as a whole, half of the products selected were produced by seven of the largest providers. The other half were from smaller providers (12 in total).

Key findings

We set out our findings below under the following headings:

1. Risk of capital loss;
2. Use of descriptions such as 'safe', 'secure', 'protected' and 'guaranteed';
3. Counterparty risk;
4. Creditworthiness;
5. Financial Services Compensation Scheme; and
6. Understandable language.

Under each heading, we have selected some text from a sample of financial promotions to illustrate good and poor practice. Where we show examples of good practice or potentially useful language, it is important that firms understand the lessons that the examples illustrate, rather than simply copying them. Firms have to consider the overall impact of their promotions: although we have focused on certain issues in this report, we assess promotions in the round and the context of certain explanations can be as important as the explanation itself. So the examples are indicative only, and are in no way 'model' disclosures.

1. Risk of capital loss

In approximately one third of the financial promotions we assessed, the explanation of the risk of capital loss was not sufficiently clear. Some promotions tried to explain the risk of capital loss in terms of 'protection', or in a qualified or opaque way.

Firms should ensure that a financial promotion for a product or service that places a client's capital at risk makes this clear. Firms must ensure that the language they use does not diminish or obscure this important warning.[6]

6 COBS 4.5.2 R (4)

Good practice

'Investing in the Plan puts your Capital at risk.

You may lose some or all of your investment.'

- This statement was on the front cover and the second page of a financial promotion. It was boxed and in larger font than the rest of the text and so was a prominent warning of the risk of capital loss.
- The warning uses clear and straightforward language.
- The risk was explained in more detail in another part of the promotion.

Poor practice

'Contingent capital protection at maturity is provided, that allows for the underlying FTSE 100 Index to fall by up to 50% at maturity'.

'Your capital is not at risk as long as the index does not drop by more than 50%'.

Consumers are unlikely to be familiar with, and readily grasp, the term 'contingent protection'. Furthermore, terms such as 'contingent protection' only *imply* that capital is at risk. Describing a *risk* in terms of *protection* may fail to get across this important message to consumers.

Using double negatives or describing the risk in positive language can obscure an important message, thereby breaching our rules.

2. Use of descriptions such as 'safe', 'secure', 'protected' and 'guaranteed'

Overview

Many promotions for structured investment products made prominent claims that the investments are 'secure', 'safe', 'protected' or 'guaranteed' or used similar language. If promotions use these terms they have to clearly and unambiguously explain what they mean. They can only be used if they are a fair and accurate description of the product.

Claims of potential benefits must be balanced with a fair and prominent indication of relevant risks. They may also need to be explained in order for the financial promotion to be sufficient for its target audience.[7]

Obscuring an important warning

Some structured investment products are structured capital at risk products (SCARPs). If a product places a consumer's capital at risk, the promotion

7 COBS 4.5.2 R (2)

should ensure that this is clear.[8] However, we have seen promotions where the risk is described in terms of 'contingent protection' or similar language. Describing a risk in term of 'protection' or using a double negative can obscure an important risk warning. This is made worse if there is a clear and prominent claim of 'capital security', and a less prominent and insufficient explanation of when capital can be lost.

In our view, it is unfair, unclear and misleading to describe SCARPS as 'safe' or 'secure'. This description also undermines the message that capital can be lost, thereby breaching our rules. The same applies to the term 'protected', unless the limits of the 'protection' are very carefully explained.

Fair language

Some structured investment products are designed to return the capital in full if held until maturity, regardless of movements in a relevant index or asset price. However, the investment is still at risk of counterparty failure and the consumer could lose some or all of their investment in this event. These products are also sometimes promoted as 'safe' or 'protected'.

In these cases the promotion will need to provide a prominent explanation of how the investment is 'protected' or 'safe'. This will need to explain the limitations of these claims - that the investment is designed to protect the investor from certain market risk, but not counterparty risk – and what this means for the consumer.

Consideration of the credit worthiness of the counterparty may also be relevant. For instance, if the product depends on the solvency of a financial institution which does not have an excellent or very good credit rating, then it may be misleading to describe the product as 'protected', 'safe' or 'secure'.

If the explanation undermines or contradicts claims that the product is 'secure' or 'protected' then it is unlikely to be 'fair, clear and not misleading'.

Misleading language

The term 'guaranteed' or reference to a 'guarantor' are likely to give the impression that the repayment of capital is assured by a separate and additional guarantee provided by a third party other than the counterparty. If there is no such guarantee then such language is misleading.

A clear explanation of a guarantee ought to explain who provides it and what its limitations may be. For instance, it would be important to know if a 'guarantor' is a firm within the same group as the counterparty as this would mean that if the group became insolvent then so would the guarantor, so negating the guarantee.

8 COBS 4.2.4 G

Poor practice

'The Guarantees are provided by major financial institutions with independent credit ratings of AA or higher. The quality and strength of the Guarantees are dependent on the continued solvency of these financial institutions.'

The description describes the counterparties as 'guarantors'. However, it is inaccurate for the counterparties' ordinary promise to repay its debts to be described as a 'guarantee'. If there is no additional mechanism to protect investments in the event of counterparty insolvency, this description is misleading.

3. Counterparty risk

If the benefit of capital 'security' is referred to, then firms need to explain any relevant counterparty risk.

Approximately half of the financial promotions we assessed were ineffective at explaining the counterparty risk in a fair and accurate manner. We considered the explanations to be ineffective if they were not sufficiently prominent, if the language was not understandable, or if they missed out key elements of the explanation.

As with all financial promotions intended for retail clients, firms must present information in a way that is likely to be understood by the target audience or likely recipient. In this case, promotions often used language that was technically accurate but unlikely to be familiar to consumers. For instance, in 25 cases firms described counterparty risk in terms of a counterparty 'failing to meet its obligations'. Promotions also did not always explain the consequence of the risk crystallising.

Describing counterparty risk in a clear and understandable way requires careful thought. In our view, a clear description should contain the following elements:

Element of description	***Example language***
What the consumer is buying	'Your money is used to buy a corporate bond from Firm A.[9] This is a type of loan to Firm A; it is legally committed to paying the money back.'
What the specific risk is	'It is possible that Firm A could go bankrupt or be unable to pay back the loan.'
The consequences of risk crystallisation for the consumer	'If Firm A collapses you may lose some or all of your money' [If this is the case], you [may][may not] be able to claim on the FSCS.'

9 We have used names like 'Firm A' throughout this document.

The example language above should not be simply copied and it merely illustrates how elements of counterparty risk can be described in a consumer-friendly way. This can be supplemented by a more technical explanation.

We expect promotions to name the counterparty in order to be able to describe the counterparty risk fairly. So, it would not be sufficient to simply state that the counterparty is a ‘major financial institution’. In addition, any description of the counterparty must be fair, clear and not misleading.

Good practice

‘Your money is invested in a Medium Term Note which is a type of Corporate Bond, which is a loan to a company. The company we’ve selected to buy the Notes (the Note Provider) is financially strong. However, there is a possibility that the company could fail. In the unlikely event that the Note Provider defaults or becomes insolvent, your investment would be at risk and you could lose some or all of your investment.’

- **What the consumer is buying**. The text uses consumer-friendly language such as a ‘loan to a company’ to supplement the technical terms.
- **What the specific risk is**. The text offers a more understandable description of the risk i.e. that the counterparty ‘could fail’.
- **Consequences of risk crystallisation for the consumer**. The text states that ‘you could lose some or all of your investment.’
- **Prominence**: The text was on page 4 in a section titled ‘risks’. It offers an early explanation and signposts to more detailed information in the promotion.

Poor practice

‘Your Original Investment is secure and the money should be returned at the Maturity Date as long as the issuing company remains solvent. Your Original Investment, along with others, is aggregated and used to purchase a Medium Term Note, which is a type of corporate bond. It is unlikely that the company, Firm B, will fail to repay this loan, but such repayment is not guaranteed, and if there were no repayment you would not get back your Original Investment.’

This text describes the investment as ‘secure’ then immediately goes on to explain how it could be lost. In order to be clear, financial promotions have to explain compelling claims such as ‘secure’. If terms like these are used, and the firm then has to explain significant caveats, this could indicate that the claim is unfair or inaccurate.

Poor practice

'The Plan and the growth it is designed to provide are dependent upon the solvency of the issuing counterparty institution at all times - your investment is at risk in the event of the issuing counterparty institution defaulting upon their obligations.'

- **What the specific risk is**. A retail investor is much more likely to be familiar with language like firms 'collapsing' or 'going bankrupt'. The explanation could have used more consumer-friendly language than 'defaulting upon their obligations'.
- Firms need to consider how familiar consumers are with terms like 'failing to meet its obligations', 'failing to meet its financial commitments', 'failing to honour commitments'. Further explanation is likely to be necessary.
- **Consequences of risk crystallisation for the consumer**. Consumers may not fully appreciate that they could lose all their money by reading the rather bland phrase 'your investment is at risk'. The promotion has attempted to explain the consequence, but the language could be more direct.

4. Credit worthiness

An explanation of 'credit worthiness' will be relevant to an explanation of counterparty risk when it is a potential concern to the customer.

Eighty percent of the financial promotions assessed gave the credit ratings of the counterparty to help explain the counterparty risk. While this can be useful information, only a handful of these promotions put the rating in some kind of context. It is not for product providers to justify credit-rating systems or particular credit ratings. However, without the context of a rating scale, or an explanation about what credit ratings are, some consumers may misread a rating. For instance, consumers may intuitively consider 'A' to be the highest rating when it is not, or that 'B' designates a good or adequate rating when it is in fact non-investment grade.[10]

Good practice

Example 1

'Credit ratings can be a useful way to compare the credit risk associated with different Plan Providers and related investments. Credit ratings are assigned by independent companies known as ratings agencies and reviewed regularly.'

Example 2

'The Medium Term Notes are provided by a company that is rated 'AA' by Standard & Poor's Ltd. Companies are rated from AAA (Most Secure/Best) to D (Most Risky/Worst) by this independent agency. Based on this rating, Firm A believes that Firm B is likely to repay its debts at the end of the term of this Plan, but this is not guaranteed.'

10 This sentence uses Standard and Poor's credit-rating scale but the point holds across other rating systems.

Example 3

'Firm B, which has been rated Aa2 by Moody's Investor Services (as of 4th July 2008) and A+ by Standard & Poor's (as of 19th December 2008)'.

- Example 1 gives a short explanation of what a credit rating is. This might be helpful as consumers may not be familiar with them.
- Example 2 goes a step further and briefly explains the scale of ratings.
- If using a credit rating, it is also good practice to name the credit rating agency and the date of the rating. This is shown in Example 3.

Poor practice

'Firm A's capacity to meet its financial commitments is considered stable by a leading rating agency, FitchRatings.'

- This statement is misleading as the term 'stable' describes the outlook, the likelihood of the rating changing, rather than the rating itself. The term 'stable' sounds more positive than the reality – in this case a credit rating of BBB, which while it may have been stable, is in fact very close to speculative grade investment.
- It would be unfair and misleading to quote a particular credit rating where the outlook is negative, without also clearly stating that outlook.

5. Financial Services Compensation Scheme (FSCS)

Any reference to the FSCS must be clear, fair and not misleading, and limited to a factual reference only.

Where a firm makes reference to the FSCS in its financial promotion we consider it good practice for it to make clear the circumstances in which the FSCS does and does not apply.

6. Understandable language

The language used in the financial promotions was, in 80% of cases, generally understandable. However, many of the firms that used clear language overall still failed to clearly explain counterparty risk.

Where promotions were unclear it was usually because the language was too technical and not sufficiently consumer-friendly. Firms must present information in a way that is likely to be understood by the target audience. Figures or percentages can be used to illustrate a point but care must be taken as they can also confuse consumers.

Good practice

- Phrases like ‘*return of 24% on top of your original investment*’ rather than ‘124% return’.
- ‘*Your return will be 2.5 times the increase [in the index]*’ rather than ‘250% participation rate’.

Poor practice

‘This is how we calculate the growth:

> *The Participation rate is 150% so you get 150% of the rise of the index*
>
> *The index has risen by 20%*
>
> *150% of 20% is 30%’*

- This text is not the simplest way of describing potential return. It might be easier to say that the investor will receive one and a half times the increase in the index.
- A number of promotions use phrases like a ‘*130% return*’. What this actually means is return of capital and a 30% return and so is misleading.

Good and poor practice guide

We have identified industry-wide failings when considering promotions for structured investment products. So we have compiled the following list of good and poor practices. The list is to help firms produce compliant literature for structured investment products.

Good practice

Investment of consumers’ money

- ✔ Be absolutely clear about where consumers’ money is invested. Explain that it is **not** invested in an index but that the consumer is lending their money to a single financial company (if that is the case). A promotion must clearly explain where the consumer’s money goes (e.g. lent to a firm) in order to explain their connection to a counterparty – and the risk this poses.

Risk to capital

- ✔ Prominently state ‘your capital is at risk’ (if that is the case).

Counterparty risk

- ✔ Explain strategies or mechanisms used to diversify or insure against the risk of a counterparty default (where relevant).

- If the benefit of capital 'security' is referred to then firms need to explain any relevant counterparty risk. Where relevant, this explanation should describe:
  - what the consumer is buying i.e. a debt security from a financial institution;
  - what the risk is i.e. that the consumer has invested in a financial institution which could default on its debts or go insolvent;
  - the consequence for the consumer of the risk crystallising i.e. losing all or some of their money.
- To give a fair explanation of counterparty risk, it may be relevant for firms to include an indication of counterparty 'creditworthiness'. An explanation of creditworthiness could be provided by giving:
  - Credit-rating agency information (including an explanation of how a particular grading fits in the overall scale); or
  - other information, based on objective data and reasonable assumptions, to indicate the financial position of the counterparty.

Clear language

- Avoid jargon. If terms such as 'counterparty', 'security' or 'MTN' are used then explain them in a straightforward way.

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Charges

- Be clear about charges. This includes initial and exit charges, and an indication of the total remuneration to the firm built into the structure of the product.
- Explain that if consumers withdraw early, they may get back less than invested because of the impact of charges (when this is the case).

Poor practice

Confusing 'protection' and risk

- ✕ Using the term 'protection' to describe the risk to capital. For instance, if capital is at risk if an index falls by 50% then the risk should be described as a risk. Using language like 'capital is protected unless the index falls by 50%' could confuse customers and is not direct enough.

Being misleading about guarantees

- ✕ Describing a product as 'guaranteed', or referring to the issuer of underlying investment as the 'guarantor', when there is no enforceable guarantee (separate to the main contract) with a third party who will meet a claim in full in the event of counterparty failure or default. Firms have to consider the meaning that consumers will take from words used in a financial promotion. The terms 'guaranteed' or 'guarantor' are likely to give the impression that the return of capital is assured by a third party other than the counterparty. If this is not the case then such descriptions are misleading.
- ✕ Describing a product as 'guaranteed' or 'protected' due to the application of FSCS cover. Firms must not give a misleading impression of the compensation scheme and must not use it as a selling point.

Being misleading about credit ratings

- ✕ Giving a credit-rating outlook without giving the rating itself. For instance, a counterparty may have a weak credit rating like 'B', but an outlook of 'stable', meaning that the credit rating is unlikely to change. However, the investor could mistakenly interpret the term 'stable' to describe the financial strength of the counterparty.

Confusing return of capital and additional returns

- ✕ Using percentages to indicate returns that include 100% as the initial capital invested – this is misleading because the original capital is not part of the return.
- ✕ Using percentages in an unclear way e.g. referring to 200% participation rates instead of, say, double the gain in the FTSE.

Unfair disclaimers

- ✕ Warning the consumer not to 'rely' on the financial promotion.

Please note, the above list is not exhaustive and is not a substitute for a thorough consideration of the financial promotion rules, together with all relevant factors such as the target audience.

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