
Economic Perspective 1

THE NEW FRAMEWORK FOR INVESTOR PROTECTION: CMND 9432

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Worried by the prospect of as yet undiscovered frauds and the siphoning off of millions from the pockets of the public to those of some crooked tycoon, the Government has in its recent White Paper (Cmnd 9432) introduced new proposals for the regulation of investment business. The new proposals are designed to provide the public with additional safeguards that prevent fraud malpractice. To this end, a statutory framework is proposed within which two self-regulatory bodies function with the aim of encouraging "the commitment of individuals in the financial services industry to high standards". The Securities and Investment Board is responsible for the regulation of securities and investments, and the Marketing of Investments Board for the regulation of marketing of pre-packaged investments.

The need for increased investor protection is not in dispute. The distress caused by the investment collapse of Norton Warburg, for example, is still fresh in the memory and the need for tighter controls self evident. The proposals for investor protection, whilst welcome, are not, however, above criticism and in some areas changes in emphasis could bring about even greater improvements than those currently envisaged. The proposals of the White Paper are designed to encourage efficiency, competitiveness, confidence and flexibility. These objectives are to be met by actions that apply the principles of prevention of fraud; the vigorous enforcement of a simplified investment law based on a clearly understood set of general principles and rules; equivalence of treatment for products and services competing in the same market; and a commitment to self-regulation. Market forces are to be encouraged by bringing the forces of competition to bear on practitioners and institutions and by providing as much

information as possible about the services and investments on offer to the customer. The White Paper makes it clear that the intention is not to relieve the investor of responsibility for exercising judgement and care in deciding how to invest his money but rather that it endeavours to strengthen, the principle of caveat emptor by reducing the likelihood of fraud.

The approach set out in the White Paper is to protect investors by restricting the range of investments and advice they are offered. Its philosophy is to prevent investors from coming into contact with investments that are not properly documented and assessed, and from being offered advice by those who might try to take advantage of them. Admirable as these sentiments may be they are unlikely to be successful. This approach forces the legislation into tight definitions of what constitutes an investment and 'investment business' since to control the investments on offer and the advice being given it is necessary to control those who are able to offer advice or sell investments.

Investments are defined to cover a wide range of securities including shares, fixed interest stock, options and warrants as well as financial and commodity futures and participatory rights in other forms of property, but the definition used excludes alternative investments such as paintings, stamps, wine and other similar assets. These exclusions are hardly surprising given the difficulty of distinguishing between legitimate collecting for fun, enjoyment or study and accumulation for the purposes of investment. Unfortunately, some of the worst excesses of the investment industry have involved just such investments and it is not too rash to predict that such assets will

feature even more prominently in the scandals of the future.

The difficulty of specifying exactly the nature of 'investment business' is recognised by the intention to cover any business which transacts business in investments, manages investments including unit trusts, proffers advice, issues promotional material or even publishes tipsheets. Certain exceptions are suggested, however, including investment trust companies, bona fide newspapers and the preparation and publication of analytical information without recommendations. Investment trust companies and their employees managing their company's investments are exempted because the Government could see "nothing to differentiate them (such employees) from the employees of any other company". It is, however, difficult to see why they should be subject to regulation any different from that facing unit trusts, given that both investment vehicles perform the same functions and are frequently managed by the same people. The inclusion of tipsheets but exclusion of newspapers and, more particularly, financial journalists represents another example of the difficulties of the Government's approach. Many financial journalists provide advice to their readers. Is there any reason why they should be exempt from the provisions of the legislation?

The proposals recognise that professionals and "people who, though not professionals, are sufficiently expert to understand the risks involved in less orthodox investments, and have ample enough financial resources to take such risks" should be allowed information and offers that are not allowable to the public at large. It suggests that such an exempt category may be defined by statute or alternatively an obligation may be laid on an investment business to exercise care and to distribute information only to persons who appear to have the requisite understanding and resources. Such provisions raise two questions. First is it right to restrict access to investment opportunities to a select group? Secondly should institutions be placed in the position of deciding whether particular individuals have the necessary resources and experience to participate in "less orthodox investments"?

These issues are important. The White Paper aims to protect by restricting access to the investment business and by regulating the flow of investments and information to investors. The cost of such an approach is to restrict the right of any individual to invest in any manner he sees fit. Individuals who would otherwise choose to step outside the prevailing investment orthodoxy, whether from ignorance or knowledge, are restrained from following their own inclinations.

The proposed legislation places particular emphasis on the authorisation of investment businesses and on a demonstration that they are 'fit and proper'. To qualify the business will need to provide information to the statutory boards about itself and the business which it proposes to conduct, together with details of its directors, controllers, managers, employees and connected persons. Exclusion may only be based on considerations of probity, competence or adequacy of financial resources, although there is no explanation of how these may be assessed. Rules for the conduct of business are outlined which enshrine a number of laudable objectives, eg safeguarding against abuses from conflict of interest, protection of clients assets, compensation for investors, disclosure of the terms of business, the keeping of proper records and the provision of investment and dealing recommendations that are adequate and reasonable "having regard to the nature of the investment and the circumstances of the client". Those offering advice are expected to "know your customer" and to tailor advice accordingly. In itself this is good investment practice but it must be recognised that ultimately decisions are made by the investor and not by his advisors. What is required is the information that enables him to make sensible and rational decisions. There is no suggestion that advisers should open themselves up to public scrutiny providing statistics on the performance of their recommendations, the results of their managed accounts or the average size of commissions paid to stockbrokers as a result of their suggestions. Information of this type would allow investors to make informed judgements about the quality of the advice they are being given and enable them to decide how reasonable the recommendations of their advisers are.

The desire to protect by placing the burden on advisers to have a knowledge of their clients' needs and requirements is reasonable. It appears to offer a solution to problems where individuals are sold investment schemes that are totally unsuitable to their needs and result in them losing all, or a substantial part of their savings. The advisers are made liable and compulsory compensation schemes will reimburse the unfortunates affected. Unfortunately, such a system requires a control of the investment business that may well prove unnecessarily restricting to other investors and perhaps more importantly, is unlikely to be successful since those who profit from the sale of such schemes will find loopholes and investments outside the scope of the Act.

To prevent conflicts of interest the proposals impose duties of skill, care and diligence as well as fair dealing and disclosure. The clients' interests must be paramount. The process of 'churning' a managed portfolio so as to generate commission income is explicitly condemned. But little guidance on the interpretation of these duties is provided. How is one to assess skill, care and diligence in making recommendations? How is one to decide if turnover is for the legitimate adjustment of a portfolio to changed conditions rather than for generating commission? Turnover of virtually all investment vehicles appears too high when judged against the findings of academic performance studies. Are we going to see the Securities and Investment Board which covers the regulation of securities and is composed of "those who provide and those who use financial services" suggesting this? Is there really any hope that investment recommendations based on techniques that have proved impossible to scientifically validate as being at all useful - the sole use of charts to make decisions being a case in point - will be deemed inadequate and not employing skill, care and diligence? The proposed legislation provides fine ringing words but will it deliver the goods? Except in the most blatant misuse of clients' funds it is extremely unlikely!

The Marketing of Investments Board, the second of the two statutory boards proposed, will monitor the marketing and advising of 'pre-packaged' investments. The rules for the Board will require that independent intermediaries act in the

interests of their clients and do not fall under the influence of suppliers. To protect customers, it is proposed that rigorous disclosure requirements should provide information on commissions and other indirect payments and benefits in kind. Insurance brokers entitled to commission from an insurance company for a particular policy will be required to disclose that payment. These proposals are long overdue. The White Paper suggests that these requirements might be implemented either by requiring specific details of charges to be given to the client or by providing the customer with an undertaking that the charges fall within limits prescribed by voluntary agreement. It is to be hoped that the first route prevails. It is clearly desirable that investors should know exactly how much they are being charged in commission and should be encouraged to shop around accordingly. The information made available to the client should not stop there. Institutions must be forced to provide clients with more information detailing how their money is being employed and the comparative success of the managers. Such comparisons must be relevant and meaningful, rather better than much current advertising which is uninformative if not misleading. Comparisons with the FT Ordinary share index, a popular standard, are biased in favour of the portfolios as a result of the method by which the index is constructed. Outperforming the FT Ordinary may just be a statistical artefact with no real basis whilst carefully selected comparison periods may present a less than fair picture to the investor. Investors should be provided with the information that enables them to spot such unfair practices.

The proposals are silent on the important role of educating the customers to make rational and sensible decisions for themselves. Monitoring the advisers is a beginning but it is not enough. Academic studies provide extensive evidence that current practices are not always beneficial to investors. Self-regulation is unlikely to be the answer in such cases.

What of Scotland in all this? The White Paper makes no specific proposals for either separate boards for Scotland or any provisions that might recognise a need for Scotland to be treated differently. If

Edinburgh retains a more traditional specialist investment business as opposed to the diversified, financial conglomerate route that many London-based institutions appear to be following, it may well be the case that the needs and concerns of the centres diverge. The Boards may not then always best reflect the views of the Scottish institutions and, more importantly, of Scottish consumers. Recognition of the distinctive Scottish tradition of somewhat conservative investment practices and of strong overseas interests should be an aim of the legislation. Consumer protection should not mean a reduction in the diversity of sound investment strategies and policies open to investors. Recognition of a Scottish dimension should not, however, be taken as an excuse for unthinking traditional policies. Low turnover may be a virtue but small holdings, excessive diversification and an inability to reap economies of scale are not.

The aims of the legislation are worthy. The mechanism to effect these aims seems somewhat weaker. The legislation may prevent the worst abuses but one cannot but have the gravest doubts about its abilities to ensure 'best practice' and to protect consumers from excessive charging, poor (but not fraudulent) decisions and biased advice. Within the suggested framework much more could be accomplished by providing investors with as much information as possible so that investors themselves are in a position to make informed judgements. This means that information must be forthcoming on all aspects of the investment process. To focus primarily on company securities, unit trusts and life assurance is to miss the important requirement for appraisal and evaluation of the entire industry by all involved in the investment process.