Nesta

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FINANCIAL PLANNERS AS CATALYSTS FOR SOCIAL INVESTMENT

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ABOUT NESTA

Nesta is an independent charity with a mission to help people and organisations bring great ideas to life. We achieve our mission through a combination of four core capabilities:

- Generating new knowledge and insights about how innovation happens in the economy, society and public services, and making this knowledge available and accessible.
- Supporting skills, methods, tools and capacity to innovate, both in leading edge fields (from digital technology to creative industries) and in fields where innovation is less supported.
- Linking diverse networks of people and organisations, and using our convening power to open up new possibilities and to help with the implementation and diffusion of innovations.
- Helping fund innovative ventures, projects and programmes, particularly ones focused on solving compelling problems. We do this as an investor, a grant-giver, and through programmes that combine different types of support.

Nesta is at the forefront of social investment, our work includes:

- Using our research capability to better understand the markets for investment and advisory services to social ventures, including looking at the role of individual investors, the role of social venture intermediaries, the regulatory environment and the demand for social finance.
- Helping to catalyse support and networks for social ventures through funding a portfolio of social venture intermediaries.
- Building a portfolio of investments in funds and new financial products aimed at increasing the supply of capital to ventures that deliver positive social or environmental impact.
- Investing directly in social ventures.

ABOUT WORTHSTONE

Worthstone was established to help to bring the social investment sector to maturity within the UK by aiming to introduce the mechanism through which this emerging asset class can be incorporated within mainstream financial advice.

As such, Worthstone has become an independent hub of specialist expertise, providing an interface for the growing community of advisers, planners and wealth managers, as well as social investment product providers, who share Worthstone's vision for seeing client money invested for social good.

The focus is solely and exclusively on social impact investment solutions for the financial planning and wealth management profession.

www.worthstone.co.uk

ABOUT THE AUTHORS

Gavin Francis is the founder and a director of Worthstone.

Antony Elliott is Chief Executive of The Fairbanking Foundation.

Geoff Knott is involved with a portfolio of social initiatives, both internationally and in the UK.

FOREWORD

This report represents a significant opportunity to develop social investment.

It raises the profile of social investment in a very timely manner, by prompting a thought provoking response from those within the financial planning community.

It alerts financial planners to a potential opportunity to lead the way, by seeking to meet the aspirations of investors who wish to use part of their wealth to bring about a positive impact upon society.

In summary, this report provides a platform to inform the debate that is needed between all parties – investor, product provider, government and regulator – if social investment is to reach the recognised asset class status that it most surely requires for it to be accepted with confidence by those upon whom its future viability depends.

We pay tribute to Worthstone who, in acting as a catalyst in the development of a robust framework around the concept of social investment, are creating a virtuous circle.

Clearly there remain challenges ahead, but this report represents a giant step forward in developing this highly worthwhile debate.

Nick Cann ACIB CFP℠
Chief Executive
Institute of Financial Planning

David Thomson
Director of Policy & Public Affairs
Chartered Insurance Institute

Nesta is pleased to publish this timely report providing evidence of why and how financial planners can help build the social investment market in the UK. The report builds on our 2011 publication 'Investing for the Good of Society', which provided the first substantial evidence of demand for social investments amongst wealthy individuals.

We know that innovative social ventures need finance and support to develop and grow more effective, lower cost solutions to the UK's complex social problems, and that is why Nesta is committed to developing the social investment market. A lot has changed in the UK social investment market over the past year, not least Big Society Capital is now providing a significant boost to the supply of capital and the number of social investment and finance intermediaries active. But building a strong social investment market also requires focus and development effort on the 'supply chain': the products, distribution channels, and communications necessary to attract social investors. This aspect of market development has perhaps been overlooked in recent times.

This report provides clear recommendations for key stakeholders who are involved in the individual social investor supply chain. The potential appetite for social investment amongst this segment of the investor base is clear – we hope these recommendations can be acted upon to strengthen and grow this flourishing new asset class.

Joe Ludlow & Isabelle Puchwein

Nesta

EXECUTIVE SUMMARY

This report represents the results of research into the relationship between social investment product suppliers and financial planners who might introduce these products to their clients. It makes recommendations which will:

- **Support financial planners to offer social investment products to their clients.**
- **Support the development of products, communications, regulation and tax in order for this new asset class to reach its potential.**

The research process captured the opinions of a sample in excess of 250 financial services professionals (predominantly financial planning practitioners). This was achieved through a series of face-to-face interviews and an online survey running concurrently. Analysis of both the qualitative and quantitative data provided emerging key themes, which were treated as hypotheses and tested further with a set of in-depth interviews.

Financial planners are at the forefront of developments within the delivery of financial services to the UK public. They act as gatekeepers, influencing the deployment of a significant proportion of the UK's wealthy retail investors' funds under management. Previous research by Nesta ('Investing for the Good of Society')[1] on the motivations of wealthy individuals towards social investment, had affirmed the importance of the financial advice intermediary channel in the role of establishing the social investment market and optimising its potential.

The financial planner's role, put simply, is to enable a client to determine how much money they might wish to designate to any individually distinct area such as retirement planning, giving, social investment, etc. and construct a financial plan that reflects the client's 'lifetime cashflow'. The general view is that social investment would come from funds surplus to an allocation that ensures financial security. This amount differs dependent on client lifestyle, and the most appropriate client is likely to be a 'high net worth investor' (HNWI). In fact, client demand from HNWIs will ultimately drive financial planners to become involved in social investment.

The Factfind/Discovery process is where the planner identifies the different goals of its clients. It provides the appropriate opportunity to explore a client's motivations concerning the intentional use of a part of their capital for the productive purpose of generating a social return as well as a personal financial gain. Questions have been developed as part of this research to give the financial planner the necessary permission to raise social investment opportunities with their client. At present it is highly unlikely that many financial planners have a good understanding of which clients would be receptive to social investment opportunities.

A 'mindset transition' is a key step for the financial planner as well as the client, getting them to create a new social investment 'pot' that is separate from financial investment and philanthropy. Many will go through a state of confusion – which may be quite short – as they try to categorise social investment and come to realise that it cannot be included in either gifts or part of an optimised investment portfolio.

Somewhat surprisingly, the report suggests that early adopters within the financial planning profession are likely to be those with a desire to do some social good through their work. This is not the same as those that have socially minded clients, although there may be a considerable overlap. Financial planners will be motivated to explore the emerging asset class and present it to like-minded clients with professional enthusiasm.

The research suggests that social investment product developers should keep products as similar as possible to existing ones with which financial planners are familiar. The innovation and effort behind the product should be confined to its social impact, explaining how it is achieved and measured. The regulatory environment and a lack of time to incorporate new processes are key drivers of this recommendation. Financial planners want to deal with product structure issues relatively easily and then focus on why a client may be interested in anticipated social outcomes.

There is a need for regular information flow to both investors and financial planners. Furthermore, the information itself needs to be easily understood and effectively communicated using media technology. Product literature needs to be at least as good as that of similar products, with the addition of clear explanations of the social impact and its measurement. As with any new asset class, there is also a need for profile-building through media presence, seminars and other initiatives to educate the financial planner and the client.

There is currently an overriding atmosphere of caution in the financial advice market. This is due to financial planners' feelings of unreasonable treatment and a lack of clarity from the FSA on promoting certain products and the suitability of advice. A key consideration in advising clients in this area will be the need for further clarification from the regulator. This relates specifically to how the concept of suitability should be understood in the context of social investment.

Finally, and importantly, the tax regime does not encourage social investment. Financial planners are familiar with advising on products such as VCTs and EIS. It is understood by financial planners and their clients that tax incentives are given to encourage wealth to be deployed in ways that are helpful to society. Encouraging charitable giving and investing in high-risk growth companies is understood; a tax incentive would be effective in stimulating interest from financial planners. Almost as importantly, the lack of a tax incentive adds a layer of uncertainty as to whether it is really good for society.

Recommendations

1. **Defining the social investment 'pot':** financial planners will need to set apart a segment of their client's wealth portfolio to hold as social investments. This has implications for administration, performance reporting, due diligence and compliance. Importantly, there needs to be a recognised UK definition of what is a social investment in the context of wealth management advice. The market is relatively young without too

many investments, but the need for a definition is likely to grow. *The social investment industry should develop a definition, preferably based on the investment 'qualifying' as a result of its social impact. A body may be required to specifically take this responsibility, not unlike the Charity Commission. The definition should be useful in the context of regulation and tax.*

2. **Financial planners' need to clearly identify interested clients:** this report contains a discovery questionnaire that has been developed and tested. *The financial advice industry should develop the infrastructure necessary to identify the suitability of social investment for its clients.*

3. **Socially motivated financial planners:** the early adopters will be financial planners and wealth advisers that are socially motivated themselves and not just those who have socially motivated clients. *Social investment intermediaries should initially focus on building relationships with financial planners who are socially motivated.*

4. **Products:** the key to success is that the product is kept as readily identifiable with the existing classes of investment product as possible. The difference is concentrated in the social impact and its effect on return. *Product suppliers should keep innovation to a minimum other than in respect of the social impact, explaining how it is achieved and the measurement of the outcomes.*

5. **Marketing materials and education:** financial planners need high-quality product information. *Product suppliers should generate materials that contain all that could be expected for a similar product promoted to the profession. In addition, it must contain clear case studies and an explanation of the social good that it is intended to achieve and the risks to the expected outcomes. The social investment sector should encourage informative media and seminars to increase the level of understanding of the asset class and specific products.*

6. **Regulatory risk:** there is a lack of clarity with regard to the regulatory position of key social investments. There are exceptions, such as VCT/EIS investments. There is an appetite for the higher-risk capital to be provided to social enterprises/social investments. The social investment asset class, due to its early-stage of development lacks the regulatory clarity of other markets. *The government and regulators should develop a clear regulatory framework in order that the market can reach its potential.*

7. **Tax incentives:** there is a disparity in that there is not sufficient tax incentive for an activity intended to generate social good. Financial planners are likely to respond positively to a tax incentive by incorporating the products in their advice. The level of the tax incentive needed would require further consideration given that this is a new asset class. *The government and tax authorities should identify appropriate means of incentivising wealthy individuals to explore social investment.*

In order to bring the social investment market to maturity, it will be important to access capital flows from the large asset owner base in the retail market. A successful strategy for growing the market will need to include those who operate within the parameters of 'retail investment advice' such as financial planners and wealth advisers. These firms have a significant influence over the deployment of individual investors' funds under management.

CONTENTS

Section A: BACKGROUND, SCOPE AND METHOD

This report is focused on understanding how social investment opportunities may be considered by the segment of the UK wealth management sector that provides regulated investment advice to retail clients. This includes those making personal recommendations in relation to a designated investment and to firms that manage investments of clients of mid net worth and high net worth, as well as ultra-high net worth.

The objective is to help accelerate the flows of capital into social investment products by understanding the requirements for distributing product solutions via this sector and identifying any barriers.

This is the first time in the UK that a research project has focused wholly on the relationship between the social investment sector and the investment adviser marketplace. The intention is that this evidence-based work provides the opportunity for stakeholders to deliver a substantiated message of value and coherent strategy to three main groups:

1. **Those providing regulated investment advice to clients, including the profession's FSA accredited bodies.**

2. **The social investment intermediaries designing product solutions.**

3. **The influencing and decision-making bodies such as regulators and government.**

Definition of the UK wealth management segment – investment advice market

Investment advisers within this community identify themselves under a number of designations in order to differentiate within a broader group, the role, type of product and service that the individual or firm offers its clients. These style terms include (as shown in Figure 1): financial adviser, financial planner, IFA, investment adviser, private banker and wealth adviser/manager. From January 2013, there will be a regulatory requirement for all of these advisers to have a current 'statement of professional standing' (SPS) which can only be issued by an FSA accredited body. There are two main FSA accredited bodies for financial advisers: the Chartered Insurance Institute (CII) and the Institute of Financial Planning (IFP). Both these bodies are also awarding bodies: the CII offers 'chartered' status with their own syllabus. The IFP offer 'certified' status which is a globally recognised professional qualification.

The difference is in the route to qualification that one follows and the emphasis on particular technical subjects of those various routes. Whether chartered status or certified status, both practitioners are known as either chartered financial planners or certified financial planners but both are termed 'financial planners'. The term, financial planner, is used in the report to cover all regulated individuals qualified to provide financial advice to retail clients.

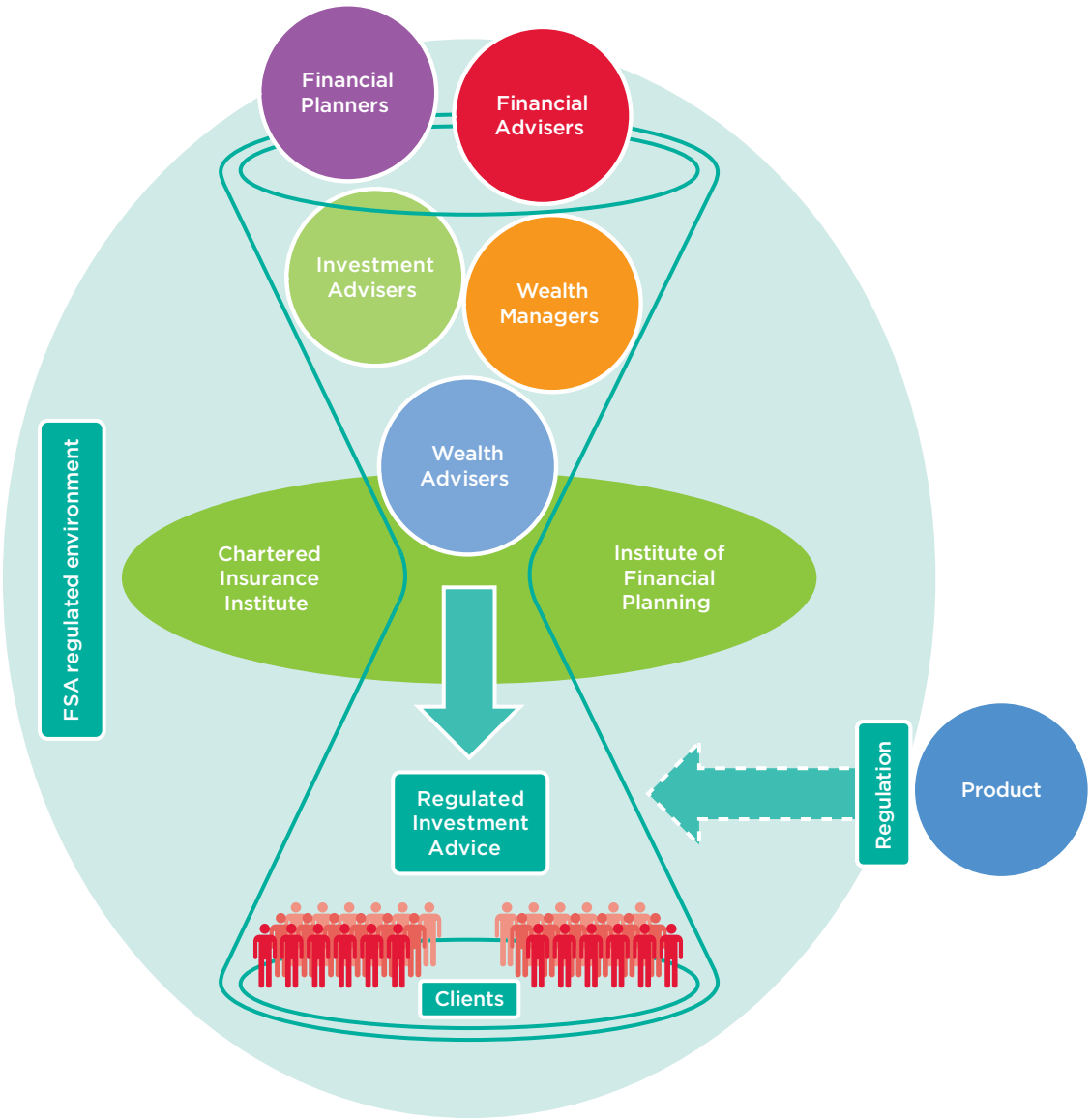
Definition of the social investment market

'Social investment' was described to financial planners as referring to investing that 'actively places new capital in businesses and funds that generate social and/or environmental good and a range of returns to the investor, from principal to above market'.[2] This is also known as 'impact investment'.

The social investments presented to them either had a lower return than comparable financial investments, or the return was dependent on factors that made the risk difficult to evaluate compared with a similar financial investment.

Both regulated and unregulated investment products are currently available and/or in development from a range of existing social investment product providers.

Figure 1: The Market



Methodology

The report presents research covering the views of over 250 financial services professionals, including those whose role it is to provide the end client with advice as well as some who provide specific outsourced services or a product offering to the financial planner. The research consisted of 41 face-to-face interviews and an online survey conducted between October 2011 and March 2012.

a) Qualitative study

Six social investment product concepts (a summary of the specifications are detailed in Appendix C) were presented to financial planners with a template of questions to elicit views, particularly relating to perceived customer interest.

Questions were asked to examine the advisory process for such products to understand constraints and weaknesses and the changes that might be required.

In-depth, face-to-face interviews with financial planners were conducted. These individuals represented firms with in excess of £4 billion of client assets (Figure 2), based in London, Bristol, the Home Counties, Anglia and the Midlands, North East and Edinburgh (Figure 3). Of these interviews, 14 were conducted to test a discovery questionnaire explained in Section B (2) and ask more in-depth questions on client characteristics and regulation, once these had been identified as key areas.

Additional meetings were held with three different compliance specialists, three investment platform providers and one financial services specialist lawyer who consults exclusively on FSA perimeter guidance issues.

b) Quantitative study

Over 7,500 financial planners out of a universe of 20,000 received a request to complete the survey and 195 responded, 49 per cent of which had achieved chartered or certified status.

The online questionnaire was split into four sections: current practice and drivers, regulatory and advisory approaches, product perspectives and finally some information about the respondent, i.e. demographics. Choices given for any questions were randomised.

Figure 2: Size of firms in the sample by assets under management (195 responses)

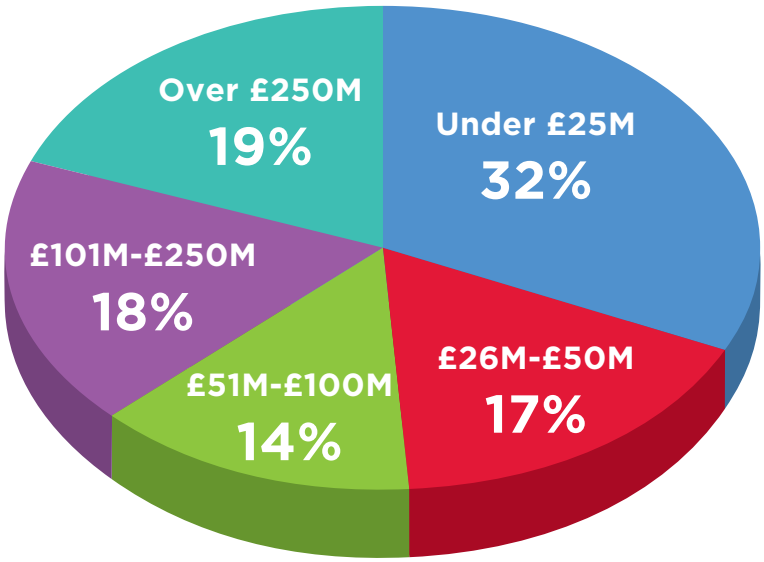
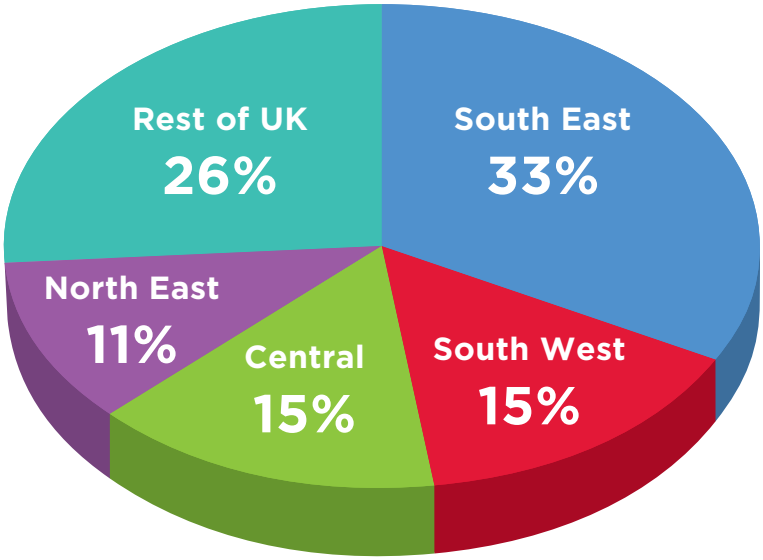


Figure 3: Geographical distribution of the sample (195 responses)



Sixty per cent of respondents had not yet recommended social or impact investment to their clients. The full data from the online survey is summarised in Appendix A.

This report continues to examine and explain seven key recommendations based on findings from the research, which evolve around:

1. **Social investments as a new asset class.**
2. **Client demand.**
3. **Financial planners.**
4. **Product structure.**
5. **Information materials.**
6. **Regulation.**
7. **Tax incentives.**

Section B: KEY THEMES

1. CLASSIFYING SOCIAL INVESTMENTS AS A NEW ASSET CLASS

The need for a definition of social investment is fundamental. Social investment is not a hybrid, but something new. It is important to be able to categorise a product as a form of social investment. The recommendation on the importance of treating social investment as a new asset class is placed first in this report because it is a key driver of other activity. Client identification, administration, education, marketing, regulation and tax will all be strongly influenced by creating this new asset class for wealth.

Research has shown that wealthy individuals who are interested in social investments can find it difficult to classify them initially.[3] Until a potential investor has differentiated social investment from financial investment and philanthropy, it will be difficult for them to commit to deploying wealth for this purpose. However, once an investor has achieved a mindset with a separate social investment 'pot', there will be an inclination to fill that 'pot' with a portfolio of different assets.

Interviews with financial planners suggest that they will go through a confused state when trying to categorise and therefore advise on these investments. Illustrative questions include: 'Are these giving or financial investments?', 'How do you get this to fit into an asset allocation model' and 'Where does philanthropy start and investment end?'.

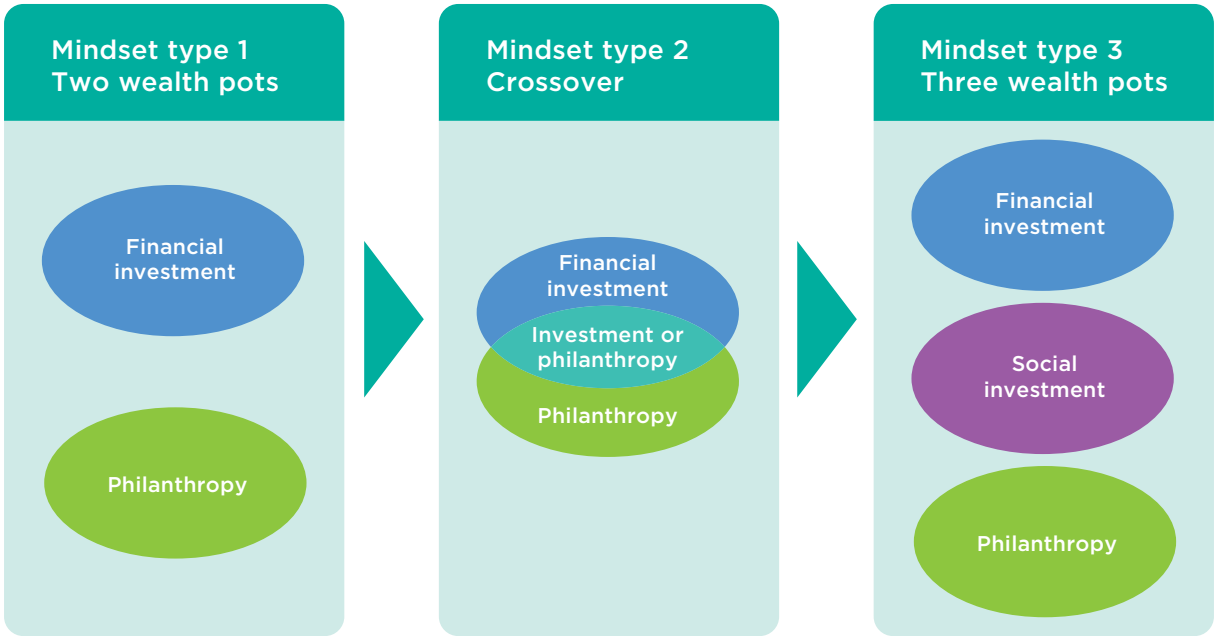
The financial planner reaches the conclusion that social investments will need to be treated differently from both purely financial investments and philanthropy. Some reached this conclusion quicker than others. The 'mindset transition' discovered in earlier research was evident and is illustrated in Figure 4.

This classification issue is critical for financial planners to advise clients in the context of wealth deployment. It has effects not only on the identification of goals, but on the reporting of the wealth portfolio, monitoring performance, marketing materials and regulatory requirements. Many recommendations in other parts of this report are dealing with issues relating to the key differences between social investment, philanthropy and financial investment. They stem from the need to recognise a new asset class.

Interviews highlighted the need for a lead on definition and terminology. Indeed, it will be beneficial to many participants in the market to have a definition. A charitable gift is identifiable by it being a gift to an organisation with a charitable objective, and the charities commission has responsibility over defining this objective. Similarly, boundaries for social investment could be set to provide a definition for this new asset class in respect of the social objective. This definition will not only be useful in financial planning, but it will be necessary for the regulator and fiscal policymakers.

Figure 4: Mindset transition to becoming a social investor

Source: How do individuals become social investors? Interim conclusions from research into the behaviour of high net worth investors, Fairbanking Foundation and Ipsos MORI, published by Nesta.



Recommendation

The development of a definition for social investment is imperative. The social investment industry and influencing bodies need to establish what will 'qualify' because so much flows from this, including distinguishing social investment for the purposes of regulation and tax incentives. The move to wealth deployment in three pots rather than two is important, i.e. financial investment, philanthropy and social investment. In many respects it is this change that reverberates through many of the following recommendations. It is the 'social good' that causes many other changes. Financial planners need to be able to identify clients interested in social investment and track the portfolio of social investments separately from investments made for financial return. Furthermore, products need to clearly explain how the social impact is being achieved.

An important aspect of education for financial planners and clients is to enable an understanding of the variety of products that meet the definition in order that expertise can be developed.

The difference between social investment and the other two pots is one aspect of the education process. At this early stage of the asset class, it is difficult to anticipate the level of demand for analysis, due diligence, monitoring and performance measurement of the social return. It is likely to grow as the market develops.

2. CLIENT DEMAND

Financial planners, as part of their approach to 'suitability', should develop the discovery process to identify those clients who may have an interest in pursuing a positive social impact through investment. Being true to their profession they will need to meet the growing demand of consumers for social investment solutions. The main FSA accredited bodies need to support efforts to stimulate awareness and encourage the inclusion of social goals as best practice for the profession. At the same time, the social investment sector needs to provocatively challenge the profession.

Ultimately, there may need to be an obligation to ask clients whether social impact forms part of their investment objective within the context of their wider financial planning goals, ideally this should even be best practice. A discovery questionnaire to facilitate this has been developed and tested in the course of the interviews with financial planners. It is recommended that this is used by the financial planning profession within their discovery and review process with clients.

The following three points are explored in more detail in this section:

1. Identifying clients who may have an interest.
2. Identifying clients' social impact goals.
3. The regulatory perspective of the identification processes.

1. Identifying clients who may have an interest

In the quantitative research client demand was rated as the foremost motivation for financial planners to engage with social investment (Appendix A, Table A2). Financial planners were also asked about the likelihood of their clients already having an interest: 75 per cent believe there is 'possibly' or 'highly likely' unidentified client demand for social investment among their clients (Appendix A, Table A1). This topic was explored in all interviews.

All financial planners interviewed could identify clients that would be interested in using their wealth for social investment. However, there was little consensus as to whether they could identify the clients who would be drawn to social investments using existing knowledge. Responses ranged from those who felt that they knew clients sufficiently well to be confident of their interest, to those who recognised that this was a new way to deploy wealth and would need to discover their clients' preferences.

Three themes emerged from responses to client identification questions: some clients want to do social good with their wealth; financial planners view relatively wealthy clients as the most appropriate social investors; some financial planners tend to assume social investors are the same as ethical investors.

Some clients want to do social good with their wealth: Financial planners have views about the non–financial interests of their clients and many representative statements support this finding.

Irrespective of whether these assessments are correct, planners were fully prepared to engage with the social impact/content of the products.

- *'When you look at client's whole situation, if their financial security is OK, then it would be OK to consider impact investments.'*
- ***'Not for those of modest means (less than £250,000 investable cash excluding property, pensions etc.) due to regulation. Have a greater duty of care for those people, and regulator likely to rule in their favour. I define modest as under £250k on cash – more comfortable with £500k. Self-made people [are] better than inherited wealth for these investments as they know what it is like to start with nothing."***
- *'Aspiration from clients to have more social impact. May be small amounts in some cases. Interested in democratising and spreading the opportunity to participate.'*
- ***'Not necessarily high net worth – satisfied own needs. Some with low requirements. It is £250k plus; however, generally it would be £1.5 million of financial assets that defines comfortable.'***

The following diagram (Figure 5) is taken from earlier research[4] into the motivations of wealthy individuals to deploy wealth in social investment. Financial planners' views align with findings from that research that clients wanting to engage with social enterprise/charity are the most likely to invest. However, other motivations were found in earlier research, such as being an early adopter and injecting a business-like approach into social activity. Hence, the financial planner may only be partially confident in the client's response.

Figure 5: Triggers/barriers in the process of becoming a social investor (investment assets over £100K)

Engagement was clearly the strongest motivator. Potential investors liked the idea of being able to volunteer, act as directors, visit the social enterprise and meet the management. Giving a sense of engagement to potential investors is key to success.

Early adopter motivation is giving an opportunity to imitate others who have decided to invest. It may develop into a habit as further opportunities develop.

The economic environment leads these potential investors to recognise the need for social investment, potentially involving taking over from some areas facing cutbacks by government.

Encouraging business like behaviour is motivational as there is a sense of a greater level of control over the social enterprise or charity when compared with philanthropy.

Recycling of the investments means there is a potential for more social effect. This is real difference with pure philanthropy and leads thoughts of it being a new category for wealth development.

Evidence is needed and could be a barrier. The need for case studies and track record, particularly for higher-risk social investments is important.

Tax incentives would be a major motivator - in addition to the financial incentive, these would be good to 'jump-start' the sector, for public awareness and to give a sense of sharing the cost/benefit with government.

All of these motivations can be made an integral part of encouraging a new investment class of social investment.

Some financial planners think of ethical investors first: this is not surprising. Indeed, in earlier research, 23 per cent of the segment likely to become social investors had made investments with ethical, community or social benefits. This was statistically significantly higher than the 16 per cent of the overall sample. However, this also means that 77 per cent of those likely to make social or ethical investments had no existing investment of this type. Although precise market size data is not available, existing ethical investors will only represent a small proportion of the clients most likely to be interested in social investment.

'Others with an ethical/green leaning, it will fit in with ethical/green approach to their make-up.'

Financial planners who felt that existing ethical investors would be the first to become social investors may not be proven correct. This reinforces the need to develop a discovery process, effectively giving all investors the opportunity to express an interest.

- *'We are familiar with ethical –[...] . You must ask the question of the client, cannot guess, have to ask specifically.'*
- ***'Make sure investment decisions are positive towards the environment and society, i.e. not negative, e.g. arms and smoking. Interested typically in ethical funds.'***

2. Identifying client social impact goals

All interviewed financial planners agreed that a single discovery question on client interest in ethical investment would not be sufficient to identify and understand any positive social impact a client may pursue through investment.

For financial planners there is a need to explore this area more thoroughly to identify consumer interest:

- *'Investments must match clients' passions – us knowing them and their personality.'*
- ***'Recognised [social investment] as having a place within the financial planning brief.'***
- *'There are lots of social investors out there they just need someone to join the dots for them.'*
- ***'...if you talk about what consumers want it will capture an adviser's interest.'***

'Being true to your profession – the financial planning community talks about goal setting with clients – some clients will want more than financial goals.'

Findings show that financial planners believe client demand will grow. Going forward, they will need to discover apparent or latent demand and evidence it, for which they will require a process.

A questionnaire was developed and tested for this research. In most cases, the planner would be comfortable using the questionnaire or some of the questions as a prompt with a client. While this would not necessarily be at the point of first interview, it would be used at some early point in the relationship, or to ascertain the interest of existing clients.

3. The regulatory perspective of the identification processes

Available guidance material, issued by the FSA in the form of a factsheet,[7] does not currently provide specific guidance and could be open to interpretation. While it does test a client's inclination to 'soft facts and customer goals', it could place more emphasises on the need for a more defined social goals questionnaire:

> When assessing a customer's needs you should make sure you consider their **hopes and aspirations plus any beliefs,** circumstances or fears and barriers to planning. This will help you clearly establish what their priorities are and ensure you are treating them fairly. It may also identify the potential for further advice and services.

Evidence shows that many planners currently make a judgment on whether a client may be sympathetic to this type of investment approach without asking any specific questions. This is a potential concern for both planners and clients because it suggests that an area of potential advice may be overlooked.

Financial planners generally accept that there is a requirement to explore in more depth and gain a greater understanding of clients' social motivations. The following comments illustrate this point:

'At the moment, it's more about our judgement than theirs.'

'You can't necessarily know that a client has a passion for social causes unless you tease this out.'

From a regulatory perspective it is mandatory to gather information regarding the investment objectives of a client, which must include the purposes of the investment. This will be explored in greater detail in the section on regulation. However, this point also relates to the need for professional indemnity (PI) insurance and the extent of exclusions, restrictions and endorsements on a policy. Two professional indemnity insurance brokers and an underwriter were consulted during this research; their view would be to 'encourage more and much fuller fact-finds' and that 'from a PI angle it would be preferable to have a tailor-made fact-find for this category'.

> *'Financial planning is an evolving profession, and financial planners will consider the widest range of solutions for their clients. To be good at this they need to have a deep understanding of their clients' goals and objectives. Philanthropy and social investing are important to consumers and therefore growing in importance for the financial planning community. The IFP is pleased to support further research in this area to establish what is possible.'*[6]

Recommendation

The financial planner is not able to identify clients who are interested in social investment at present. In order to enable a planner to determine a client's propensity for social goals, suitable questions should be included within their discovery process.

It is evident from the research that financial planners believe that there is interest among their clients in social investment. It must therefore be of importance to financial planners to explore with a client whether positive social impact is considered as an investment objective within the context of their wider financial planning goals. There is a requirement for the main FSA accredited bodies to support and encourage this behaviour in 'accredited firms' as part of best practice. This may be achieved by acting as a conduit to raise and stimulate the debate, seeking advice from members, development of training and competence modules for the members as well as establishing a requirement for continuous professional development in this area.

The financial planner will have a process with clients for identifying financial goals and developing a plan. Currently, it will not include questions which explore any appetite that a client may have to do social good with their investment capital. It is apparent from this research that financial planners need to gain a view from clients about social investment.

The initial face-to-face discovery meeting between client and planner, when goals and objectives are identified and prioritised, provides the opportunity to begin exploring any appetite a client may have to do social good with their investment capital. Some planners felt that if an interest is identified with a client it may warrant a separate follow-on meeting to explore the area specifically. It was also suggested that this would be a relevant subject for review meetings with existing clients.

Three core variables converge to compose a financial plan: the client's goals and objectives, the level of resources available to achieve them, and the risk they are prepared to take or their capacity for loss. In particular, the interplay between goals and risk is the key to a robust and compliant process. If social goals do prove to be important to a client, they will need to be measured against that client's attitude to risk, i.e. any potential trade-off between financial return and the desire to see social good being achieved.

To support this recommendation, overleaf is an outline discovery questionnaire, developed and tested for the purpose of this research, which can be adapted for financial planners seeking to hold more in-depth discovery discussions with their clients.

Suitability questions for the financial planner to use

Questions in the recommended discovery questionnaire have been refined during the interviews with 14 financial planners.
From this research and the regulatory framework, it is clear that both understanding client motivation and being confident that they, in turn, understand the nature of any implicit risk are critical.

'For all of us there are things that we would like to achieve in our lives; in order to achieve them we need to be focused and financially 'organised'. This is the essence of financial planning.'8

Below is the rationale behind the five questions:

Question 1 is based on research published by Nesta that identified key indicators of an interest in social investment.[9] There are three sub–questions, and if any of them is answered positively it would indicate a potential interest in social investment. These were viewed by financial planners as permission questions to indicate whether it was worth asking more about specific areas of interest.

Some financial planners thought that all clients would 'want their money to do some good as well as provide me with a return'; others thought that a relatively low proportion of clients would answer this question positively.

Question 2 is aimed at finding people that have acted on their ethical values within existing investment decisions.

Question 3 makes use of the finding that people who have allocated some of their time to community activities are more likely to be sympathetic to the notion of allocating some of their wealth to social investment.

Questions 2, 3 and 4 enable the client to indicate areas of social need and geographic regions in which they have some empathy. Many financial planners recognised that clients who have an interest could have reasons for interest in causes and places that they would not previously have known from discussions.

Question 5 is a key question because at a high level it is identifying whether the client would like to be presented with investments that may involve a sacrifice of income or capital in order to achieve the social objective. Financial planners were uniformly interested in asking such a question and, following some refinement, this question appears to be worded well.

YOUR LOGO HERE

Factfinder/Discovery questionnaire

The purpose of the following questions is to obtain from clients sufficient information to identify whether they could be
approached with opportunities to deploy their wealth in social investments.

Social Investments are *investments intended to create positive social impact beyond financial return*:[10]

- Providing capital
- Expecting financial return
- Business designed with intent (fund managers or companies)
- To generate positive social and/or environmental impact

Business sectors:

Basic needs: agriculture, water, housing

Basic services: education, health, energy, financial services

Investment instruments: debt, equity, social impact bonds (not a bond!) – returns may be linked to metrics of social performance such as preventing children on the edge of care falling into care.

Q1. Background for the adviser. From previous research among high net worth individuals into the motivations behind a wealthy individual becoming a social investor, we know that there is a correlation between the level of agreement with the three statements below and the likelihood of engagement with social investment. The most statistically significant questions for a financial planner to establish which of their clients will be most receptive to this investment opportunity are the following statements:

Ask the client whether they either:

1. Strongly agree ☐ **2. Tend to agree** ☐ **3. Neither agree or disagree** ☐ **4. Tend to disagree** ☐ **5. Disagree** ☐

1. When investing, I would like my money to do some good as well as provide me with a return. ☐

2. My investment portfolio reflects my ethical values ☐

3. I like to be actively involved in local community activities ☐

If there is agreement with any of these statements, then ask the following four questions:

Q2. Are there any areas of social good that may interest you? (The list below is not exhaustive – tick all that apply.)

Microfinance (small loans to individuals so that they can start to trade) ☐	Employment opportunities (e.g. homeless, disabled people, youth, etc.) ☐	Young people (e.g. education, children in care, skills training, etc.) ☐
Social housing or regeneration ☐	Environmental (e.g. renewable energy, forestry) ☐	Rehabilitation, e.g. working with ex–offenders, addicts ☐
Rehabilitation, e.g. working with ex–offenders, addicts ☐	Local community projects ☐	Ethical consumerism (e.g. Fairtrade) ☐
		Other (please specify) ☐

Q3. Are there any areas of social good which are of particular interest or that you particularly identify with?

Q4. Are there any areas of the world that you are interested in influencing (tick all that apply)?

Area of UK (specify) .....

Americas ☐ UK ☐ Asia ☐ Europe ☐ Australasia ☐ Africa ☐ Middle East ☐ Other (specific regions or countries) ☐

Q5. Social/community investments may not give the same financial returns as 'traditional' investments. To what extent are you willing to sacrifice some financial return for achieving social good?

A. Lower income compared to a similar conventional investment ☐
B. No income – all used by social enterprise ☐
C. Potential loss of capital ☐

3. FINANCIAL PLANNERS ENABLED TO 'PUT SOMETHING BACK'

It is crucial to identify financial planners who are inclined towards doing social good, as these are likely to be the early adopters. This section highlights three types of financial planners in terms of their approach to social investment: socially driven, client driven and revenue driven. The 'socially driven' financial planner is likely to drive forward the market in the early stages. This has implications for product providers and all those who want the market to reach its full potential.

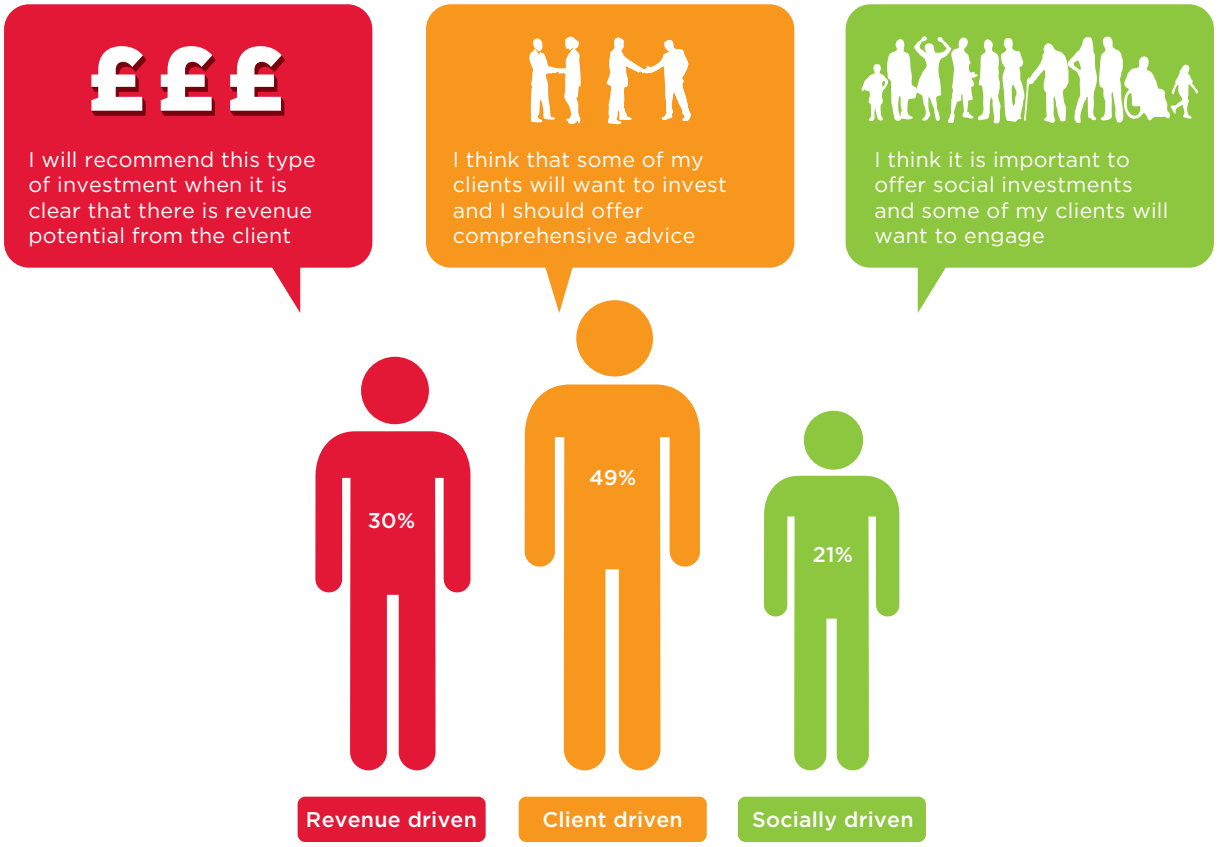
The second most important driver influencing the decision to recommend social investment to a client was the desire of the financial planner him/herself to do social good (see evidence in Appendix A, Table A2). Illustrative comments include:

- *'This helps us as a business to put something back. It's a natural extension of what we are doing with charity giving. We can do better especially if clients behind us disproportionately leverage money.'*
- ***'For me and my clients, we can be seen to be doing something good in the world with the potential to get the money back with some return. It is a chance to get me and clients involved.'***
- *'We need to separate out the social community investment portfolio. We would have a separate fee arrangement – reduced fees so our investment is with you, Mr/Mrs client, in this.'*

For financial planners who identify with social investment, their desire to do social good is the main driver for involvement with this new market. The quantitative survey (192 responses) provides strong evidence to support this point (see Appendix B, Table B1). This even ranks ahead of demand from their clients. The question they were asked was: 'On a scale of 1–10 (1 low, 10 high), where are you personally with a commitment to investing for the benefit of others/societal change, i.e. a positive impact in society?'

Figure 6 summarises the result:

Figure 6: Financial planner profiles



The degree of identification with social objectives affects the response to other questions:

- When the social investment is described as producing reduced levels of returns from 'traditional' long-term investment, 66 per cent of the high identification group are interested, but only 16 per cent of the low identification group.
- Similarly, if the expectation was that less than principal would be returned, 24 per cent of the high identification group would be interested whereas none of the low identification group would have an interest.
- Intriguingly, only 60 per cent of the low identification group would be interested in advising on social investments even when the return was comparable to 'traditional' long-term investment (see Table 1 on page 24).

Table 1: Interest in return on investment (188 responses overall)

Question	Low Identification 1–3	Overall Survey	High Identification 8–10
If a client expresses a desire to 'achieve social good', how interested are you in advising on impact investments based on the following returns on investment? % responding interested or very interested.			
a) Comparable to 'traditional' long–term investment	60%	71%	89%
b) Reduced levels to 'traditional' long–term investment	16%	36%	66%
c) Principal at least to be returned	40%	55%	63%
d) Less than principal to be returned	0%	12%	24%

It is noteworthy that financial planners with high identification were more than twice as likely as those with low identification to agree that retail clients should be surveyed about their appetite for social investment. There was a similar difference in agreement that retail clients should be advised about social investments and on the potential suitability of unlisted and illiquid social investments if they are limited to a small proportion of a portfolio (see Appendix B, Table B2).

Financial planners with high personal identification to investing for social good are more than twice as willing to advise on social investments even if financial returns are reduced. This is in line with the finding that financial planners with low personal identification with investing for social good are more financially driven.

Financial planners with high or low personal identification with investing for social good are spread in similar proportions across style of adviser, size of firm by number of clients or assets under management, location, etc. This research concludes that financial planners who identify with a social good objective are not grouped at present in any type of firm.

Recommendation

Social investment product suppliers need to identify, focus effort on and support the early financial planner adopters. Those in this group clearly indicate that social good motivates their involvement in this market. When receptive clients overlap with receptive financial planners, social investment advice is most likely to be given.

A social investment product supplier might automatically ask a financial planner: 'Do you have clients who are interested in products which have social content?' However, research shows that a first and more effective question should be: 'Are you interested in products which have social content?'

Effort is needed to target receptive financial planners for the market to develop, and research shows that more planners are likely to follow once there are signs of maturity.

4. STANDARD PRODUCT STRUCTURE, BUT WITH SOCIAL IMPACT

Products should be as similar to conventional investments as possible with an emphasis on highlighting the social component and the effect that this is having on the risk and return of the investment.

Initial face-to-face interviews aimed to test and position social investment with planners and identify suitable product structures. The evidence put forward in this section reflects discussions around specific investment product concepts (see Appendix C).

'We need a good understanding of the product – detail, tax, social, etc. – a lot to understand.'

'As with any product, care would be needed to ensure that the nature of the product and the financial risks were understood and disclosed to clients in a suitability letter.'

The risk factor

Product issues raised are largely to do with risk and regulation, with the focus being on risk to the financial planner of providing incorrect advice. The concern could be the response from the customer or the response from the regulator; the two being interrelated.

In the product testing phase, financial planners emphasised that they spend an increasing amount of time monitoring risk. Product selection in particular is under intense scrutiny from the regulator and therefore requires increasing resource spent on managing and minimising risk. It is both good practice and a regulatory requirement for a firm to have robust oversight processes in place, as well as adequate risk management systems.

'Firms are operating factory type regulatory regimes.'

Familiarity

Financial planners tend to prefer understandable products; it is critical for both financial planners and their clients to understand the product in question, including all the risks involved.

'Advising clients on social investment with risk in the back of your mind.'

The time it takes to review an investment, relative to the number of clients for whom the investment opportunity would be suitable for promotion, is a non-negligible factor to take into account. The more resource is required to understand a product, the less likely that product will be considered, in particular if it only meets a relatively

small number of clients' objectives and comes with a limited access period. This suggests that mainstream products are required, i.e products which are relatively easy to understand and are appealing to many.

'We need to understand risk just like any other investment.'

Product structures

Confidence in a product's legal structure as well as the underlying asset class is another factor that the financial planner must consider. Introducing a recognisable product structure around the new concept of social impact increases the financial planners' confidence of fully understanding the risk involved, being able to explain it to a client and that client understanding the product and concept.

- *'From an adviser point of view in this litigious world the adviser needs to be confident that the investor can understand the concept – for the investor to understand is critical.'*
- ***'I need to feel secure that everyone knows what they are doing.'***

'Factor in a lot more involvement going forward for something a bit more 'off the wall' because client thinking '...(my IFA)' put me into this if things go wrong – you don't get paid for this!'

The form (i.e. legal structure) and substance (i.e. charity/social enterprise) of products were separated out by financial planners when faced with a product they could not immediately identify with. Products which were not readily recognisable and frequently used by a financial planner would attract queries around structure as well as the underlying social investment:

- *'Do I know enough as an adviser – if push comes to shove am I qualified to advise a client on this?'*
- ***'We need a 'kite mark' on products if it meets certain requirements.'***

Quantitative data from the survey confirms these findings. The most important product characteristics are shown in Table 2.

Table 2: Extract of top six from 'Product Characteristics' (optional) (143 responses) (full table (A5) shown in Appendix A)

In your view, how would you rate each of the following potential 'impact investment' product features in terms of their importance to a client who is considering an investment?	
Characteristic	**Weight**
Risk is clearly identified	470
Covered by the Financial Services Compensation Scheme	388
Any fixed–term nature of investment is clear	380
Availability of professional advice	378
Reputation of product provider	348
Track record of financial return	334

As these figures show, many characteristics scored above social impact issues, indicating that financial planners need to understand risk as a priority before considering social impact.

'Does this stack up risk–wise and financially?'

As these figures show, many characteristics scored above social impact issues, indicating that financial planners need to understand risk as a priority before considering social impact.

This refers not only to client risk but also to financial planner risk around promotion, distribution and suitability of products to clients (see Regulatory section in Appendix D). Below is a list of characteristics summarising how financial planners understand their exposure to risk:

1. Risk in the investment can be explained to the client.

2. If an investment is not covered by the Financial Services Compensation Scheme (FSCS), the risk to the financial planner is in the event of investment failure. Without the safety net of the FSCS, the client is likely to complain to the financial planner and they in turn will look to their professional indemnity (PI) insurer to see if they will cover them.

3. Fixed term – ensure that the client understands that if their circumstances, aspirations or goals change that the investment may not be liquid within a certain time frame.

4. Availability of professional advice – whilst the financial planner retains the regulatory responsibility and risk, they are exercising prudent oversight and risk management in understanding other professionals opinions on the subject.

5. Reputation of the product provider gives confidence in the ability to deliver and lowering the perceived risk.

6. Track record of financial return is the financial planner understanding the track record, so that they can demonstrate their understanding of how and why the investment has performed. The financial planner is taking less risk if advising on a product that has a track record.

It is important to note that none of these points differ from conventional investment products, nor relate specifically to social impact.

Recommendation

The products financial planners were comfortable with or liked were those that mirrored the products they are already used to advising on. Product providers should create 'familiar' products in order to connect with existing financial planner portfolios and processes. There should be clear explanations as to how investment returns are generated and social impact is achieved and measured.

The research shows that the quality of materials produced by product suppliers is important. Communication needs to be at least as good as that which is available from the traditional investment market, with a specific focus on the objective and measurement of the social content.

5. MATERIALS FOR FINANCIAL PLANNER DUE DILIGENCE AND CLIENT EDUCATION

Two main perspectives emerged as driving this theme; managing risk within the financial planning process and, from a strategic marketing perspective, growing client and financial planner demand.

The point to do with managing risk for social investment is really no different from financial investment. This is a highly regulated environment, and a priority for the financial planner is to ensure that the consumer's needs are met with a suitable investment solution. As can be seen from the survey evidence (Appendix A, Table A4) it is primarily managing the risk in the financial planner's business operation which is driving the communication required. This is vitally important to financial planners as it can help to protect them and their clients by ensuring that everyone understands the opportunity and the risk involved and manages expectations for social and financial outcomes.

As this is a new area of investment and advice for most investors and financial planners it is not surprising that most of those interviewed talked about the need for materials to aid understanding of the new asset class and the individual products. There is a need to enable and equip the opinion–forming clients and financial planners who will lead in this area. The earlier Nesta research[11] among HNW investors identified the need for case studies in order to explain clearly to the potential investor how social good results from the investment.

Comments from the interviews were grouped into the following four topics. Different views were expressed by the various planners. This section captures all these views rather than attempting to extract the most important:

1. Materials to be modelled on other investment products with a focus on the social content (marketing and risk)

Financial planners are seeking materials of the same quality and frequency as those which a planner or investor would expect to be available for a traditional investment. This point came across most strongly when discussing VCT–type products. It was relatively straightforward for the financial planner to envisage the materials. A key requirement was to have information on the specific types of social investment, similar to the information on the specific companies included in a VCT.

2. Educational materials for managing risk and process (marketing and risk)

Financial planners expressed a need to be educated in this new area, specifically on the following subjects:

Educational – generic support independent from the product providers.

Due diligence – evaluating social investment opportunities to determine whether they could be suitable for clients.

Investment structure – It is more important to be able to point the client to where the social return comes from and how the product works.

3. Positioning of the social investment content (marketing emphasis)

The social impact focus should be designed to engage the potential social investor and to make it straightforward for the financial planner and their client to identify with the social issue being addressed.

There are polarised views as to whether information should be 'tugging at the heart strings' or not. However, most financial planners agree that this is more a question of understanding the opportunity and any risk (both social and financial) rather than an emotionally driven or quantified social return analysis.

The social content should include case studies – examples are important as there needs to be evidence of the effectiveness of the social intervention.

4. Market awareness/endorsements (marketing emphasis)

In order to assist with growing client demand and credibility for this sector, financial planners identified a need for media coverage and PR. Using the national (personal finance) press and financial publishers that target the audience groups of financial planners and investment professionals was highlighted as the most effective strategy. Articles and news coverage are required to challenge investors and the financial planning community to assist in stimulating the debate.

When talking about the 'crossover' with social investment, one planner said:

> *'It is an essential crossover to put the fund information into an understandable format with which the assessor would be familiar.'*

Recommendation

It is extremely important for the development of this asset class that social investment product providers *develop marketing material which prioritises the need for clients to fully understand the concept as well as any inherent risks within a product.* From the perspective of the planner, these investments need to be considered in a different light from traditional investments. The key will be agreeing with the client a potential sacrifice of financial return with an expectation of social impact. This requires communications with absolute clarity and is a critical success factor to the financial planner.

One of the fundamentals in demonstrating that this investment sector is credible is *presenting investment information in an acceptable format* to the recipient. At this early stage of the market, with little track record available, the delivery of education and information is a crucial trigger for development of acceptance.

There needs to be a *multi-faceted press campaign* in the national and industry press and seminars for financial planners from product providers and independent third-party advocates. At this early stage, the events could be generic in nature and provide independent and evidence-based education as well as case studies and stories.

6. REGULATORY FRAMEWORK – CLEAR AND PERMISSIVE

Clear guidance is needed urgently from the FSA to clarify how social impact might be included as an investment objective within the overall financial planning goals. Without this, the asset class will not fulfil its potential.

The overwhelming response to the regulatory framework as it is perceived by financial planners currently is that it is not clear and this has a number of consequences for the planner (these are explained more fully in Appendix D). Currently, there is a concern as to how a social investment product could be demonstrated to meet the mandatory suitability assessment required from the perspective of risk return optimisation.

If social goals do prove to be important to a client they will need to be measured against that client's attitude to risk, i.e. any potential trade-off between financial return and the desire to see social good being achieved (see Section C, 'Conclusions').

The following comments illustrate this:

- *'The market for these products is not the ordinary public. Compliance would ask "why".'*
- ***'We have to fully document risk to client. A lot of financial planners have been burnt.'***

Further questions in secondary interviews highlighted the following key issues for financial planners:

- **Fear of the regulator.**
- **Unregulated product risk to financial planner and investor.**
- **Professional indemnity (PI) insurance exclusions.**
- **Changing the goalposts.**
- **Time and effort required for due diligence.**

Fear of the regulator

A feeling of being unreasonably dealt with by the regulator creates an atmosphere of caution or fear. This leads to a marked reluctance to look at anything new unless the risks are very clear.

'Alternative investments are struggling. Adviser is under pressure not to recommend alternative investments due to professional indemnity and compliance issues.'

'There is a real issue with the FSA – financial planner has to be very careful. Go through a time-consuming process and if you are not earning anything that could be a bit of an obstacle.'

"One of the biggest things is fear. FSA has brought court cases and hit financial planners who have given reasonable advice at the time and given the facts known. However, they have been judged on new legislation retrospectively, often when just doing their job, e.g. saving tax."

"There is a real fear among financial planners of how new products and institutions are viewed by the FSA. Products and institutions both need to be regulated. Then we need to understand investment risk. This has been the stumbling block as the FSA work with hindsight and seem to require that financial planners should have understood all the risks – even if not apparent. They question the due diligence retrospectively."

Both understanding client motivation and being confident that they, in turn, understand the nature of any implicit risk are of critical importance. Without specific guidance from the regulator in this area, financial planners are discouraged from providing advice due to the significant perceived risk of the quality of this advice being seen to be unsuitable.

Unregulated product risk to financial planner and investor

It is evident from the research that unregulated collective investment schemes (UCIS) are currently under considerable scrutiny. This warrants extreme caution with regard to promotion and suitability from financial planners.

'If it's regulated you have a bit of comfort around it. If it is unregulated what comeback is there? Most advisers will shy away from unregulated. A planner will think risk first, risk to me and then risk to the client – we're all about reducing risk.'

'If it's not a regulated product the vast majority of our clients would not see this due to regulatory fears. Have I correctly identified the appropriate client? Could get hammered by PI insurer and regulator.'

Regulated products are favoured by most financial planners as can be seen from the quantitative survey results, which showed product regulation concerns as the top hindrance (Appendix A, Table A3).

Professional indemnity exclusions

Another consistent theme which emerged around regulation was the importance of the extent of cover offered by their professional indemnity (PI) insurers. In view of the prominence that this factor seemed to have among financial planners, specific advice was sought from two PII brokers who specialise in finding PI insurance solutions for financial planning firms. The underwriting policy is driven by the FSA and Financial Ombudsman Service (FOS) experience of rulings. It is not surprising that professional indemnity insurers consider these judgements to identify specific areas of risk.

'Have to have PI to practise. Can't trade without it. There are a growing number of exclusions and ever more capital adequacy required by the financial planner. When an organisation [product provider] fails, there is scaremongering as a lot of PI companies have exclusion when the company goes bust. Need viability of organisation information and how much due diligence available on the organisation, so financial planners can look under the bonnet.'

'Due to 'PI', the financial planner must be 'authorised' to invest in such assets.'

Moving the goalposts

As well as fear of the FSA judging financial planners retrospectively, regulatory changes to the advisory process are also being introduced:

> *'Big concern/hot topic at the moment with the FSA is 'capacity for loss' – flow as part of the 'attitude to risk' conversation. FSA's directives on 'attitude to risk' show concern that financial planners are not evaluating a client's understanding about potential for losses, so it will go as far as to stipulate you have to talk about figures rather than just percentages.'*

Time and effort required for due diligence

Regulation is absolutely critical and time consuming for anything new.

> *'Issues on due diligence. Financial planners are time poor, busy practice. How do I get my head around the various structures/time opportunities? Don't know how to record it, don't know how to review it, people need a helping hand. At least a guidance paper from the FSA on parameters for social investment. This would be a huge step forward.'*

Regulation changes

Specific suggestions were made on how regulations should be relaxed for social Investments:

A. Clear FSA guidance is needed

> *'We need to understand how FSA views the class, provider, product, etc. The FSA are too retrospective.'*

> ***'We need at least a guidance paper from the FSA on parameters for social investment. This would be a huge step forward.'***

B. Provision for investment write–off as a gift in retrospect if investment does not provide a return of capital.

> *'Warn clients that investment could fail and if so could be written off as a gift and that retrospectively be applied i.e. counts as a charity donation and therefore tax code gets adjusted.'*

C. Covered by Financial Services Compensation Scheme.

> *'The Financial Services Compensation Scheme doesn't cover many areas. Not a deal breaker. May make the investment more palatable for the smaller investor.'*

Recommendation

This is a key issue for HM Treasury and the work undertaken here is a clear and substantive message from financial planners which should inform that debate.

Work is needed on the regulatory framework for social investments. Ultimately, there is a need for the FSA to establish clear guidelines around suitability to provide financial planners with a frame of reference. Consistency is required, together with a set of understood and agreed practices and procedures.

The difficulties with regard to assessment of suitability lie with the FSA potentially interpreting and applying traditional concepts of 'investment objectives' and 'risk' to a suitability recommendation of a social investment product.

Input has been obtained from a financial services lawyer who specialises in FSA perimeter issues. Under the current regime, he recommended that clarification is required at both European (European Securities and Markets Authority 'ESMA') and FSA levels in the following areas:

1. Can 'investment objectives' be understood as including social impact as well as financial returns/security etc.? Specifically, the financial planner would need to know if the answer would depend on whether social impact is a primary, equal or subsidiary factor?

2. 'Social impact' tends to be unique in each situation, uncertain and to some extent subjective. How does a financial planner/manager assess this? How is the achievement of the objective to be measured? How does this correlate with the 'risk' involved? For example, an investment may be financially successful but turn out to have little or no social impact (or even the opposite) at one end of the spectrum or be highly successful in impact but lose its backers all their money at the other. What guidance can be given on how the 'suitability' of these potential outcomes may be judged?

3. Would it be permissible (on one suggested model) to set aside a client's 'surplus' funds (after all conventional investment needs reasonably catered for) as designated for social investment but being accepted as 'at risk'? It is accepted that even if this approach is permissible, the challenges indicated at (1) and (2) remain to be considered.

4. Consideration should also be given as to how suitability is to be assessed for a client of modest means, who is insistent on risking capital in social investment even if this means their conventional investment needs suffer.

7. TAX INCENTIVES

To be confident of getting onto the 'radar' of financial planners and other professional tax advisers from whom business is referred, a tax incentive is required. The area of tax advice is confirmed in the research to be of prominence in many clients' financial plans and therefore a product which can be utilised for meeting a tax planning solution will gain attention.

- *'The tax break or 'tax play' is the single biggest motivator in our armoury.'*
- ***'As part of maximising the return for a client it is very important to consider the tax position in balance with the underlying investment.'***
- *'The tax system is the obvious way to make these investments attractive.'*

During face-to-face interviews, this research introduced specific social investment product concepts (Appendix C), two of which were packaged in an EIS and VCT wrapper respectively. There was a consistently positive response to these product types, even from financial planners who were less enthusiastic about advising their clients in the area of social investment. There is no doubt that offering a mainstream tax incentivised product, which is recognised by financial planners, brings social investment opportunities onto their radar.

- *'If you can get a return, tax relief and do good that's what is required.'*
- ***'VCT ... now you're in a different league ... now in an area where you (the financial planner) can talk to accountants ... now you are in an area where advisers who are any good are comfortable!'***
- *'The tax tail wags the investment dog. Tax benefits make a product more attractive. For clients who pay higher-rate tax the VCT sits behind a pension contribution.'*

As financial planning practices have evolved into 'advice-led' business models there has also been more focus on segmenting the client proposition in order to provide a broader value proposition, thus improving the potential for client retention and the growth of revenue streams. Discussions with financial planners highlighted popular thinking around social investments being for relatively wealthy clients, in their current form (as discussed in Section 3). This is where most financial planning business models are focused, with a client proposition aimed predominantly at the higher-rate taxpayer. The VCT is a product which would be considered for higher-rate taxpayers in the appropriate circumstances as a tool to maximise potential tax-incentivised returns.

Another relevant factor is the way in which a financial planner targets growth in their own business. It is important to understand the context of the business development strategy of many financial planning businesses before realising the significance that a tax-advantaged product offers. Most financial planning practices will have, as part of a growth strategy, the aim to build business referrals from professional connections. This would include firms of chartered tax advisers and chartered accountants as well as lawyers, all of whom have an interest in advising their clients concerning mainstream tax-advantaged strategies and investments.

'We have a chartered tax adviser here'

EIS and VCT products are generally regarded by financial planners as higher–risk investments. This is as the government intended and why they attract tax relief, by their nature targeting flows of higher–risk seed capital to emerging new enterprises. As a result, there is unlikely to be a situation where a client's expectations are mismanaged in terms of the perceived investment risk of the underlying investments or capacity for loss. Interestingly, a small number commented that, from a client perspective, in the event of potential losses in social investment VCTs, such losses may be more palatable than had the investment been designed to deliver financial returns only.

'...at least the money was lost in a good cause!'

Some financial planners with experience advising on VCTs stressed the importance of having confidence at launch that a VCT will have the ability to raise significant capital (a figure of £20 million was mentioned in one instance). Otherwise, overall costs might be in danger of outweighing the benefits. In addition, a product open to investors over two tax years could overcome the potential problem of a limited time horizon for investment.

The longer–term and early–stage nature of social investments is a consistent strategic fit with financial planners' approach to VCTs. Financial planners will consider VCTs for those clients with wealth surplus to their future income requirements and who have the capacity to lose the principal invested. Generally viewed, the investments placed in VCTs are as capital which could potentially be lost without impacting a client's financial goals and aspirations. These investments can be viewed as 'patient capital' as the plan may be to hold the allocation to death in order that any latent capital gains tax liability from the client's estate would expire. In many cases the financial planner will seek to review the VCT investments on a five–yearly basis to maximise the potential opportunity to take tax–free gains or losses and reinvest, thereby recycling the capital for a new series of potential tax–free gains.

Recommendation

Financial planners recognise the appetite from their clients for higher–risk capital for social impact within a tax–incentivised environment. Currently, the most recognisable, fit for purpose and readily utilised structures for financial planners are EIS and VCTs. While these work for financial planners, they are not flexible enough for many social investment opportunities. A simplified set of rules to these schemes is required to broaden the scope of options, to include as many social ventures as possible.

The overall recognition of the VCT and EIS product concept by the financial planning profession would seem to overcome concerns of compliance and regulation. In addition, the longer–term perspective taken on investments in this category, the willingness of clients to take risk and their greater capacity for loss would seem to point towards a consistent fit with financial planners' current view of where social investments could be promoted and suitability evidenced for the appropriate client.

A tax–incentivised product will generate significant interest from financial planners; it is important that the government and tax authorities consider the appropriateness of the fiscal regime for this sector. The tax incentives for charitable giving and investment in high–growth companies are indicating that a social good is expected to result. If a social investment is generating social benefits, a tax incentive is a reasonable expectation. The amount of the incentive was not examined in this research. However, currently these are geared predominantly towards high risk capital. There is an opportunity to offer a tax incentive on a lower risk debt instrument (e.g. a lower tax relief on entry and no tax on the coupon) which would fit with current financial advice criteria.

An investor could have the opportunity to develop a social investment 'pot' with a high risk VCT/EIS investment together with a lower risk/debt product; the blend of tax incentives having motivated the client.

The significance of the tax incentive as a motivator for financial planners and their clients is so strong that it may not need to be as substantial as for other tax–incentivised products to generate interest. It is important that it is not too complicated and does not create additional due diligence.

Section C: CONCLUSIONS

The evidence provided in this report should help stakeholders to formulate informed strategies in order to fully develop the market for social investments among financial planners and their clients.

Recommendations are directed to each of the four following stakeholder groups:

- **Financial planners – providers of regulated investment advice to clients.**
- **The profession's FSA accredited bodies.**
- **Social investment intermediaries designing product solutions.**
- **Regulators, government and other influencing bodies.**

Each of these stakeholders has a distinct role to play in enabling the financial planning profession to act as a catalyst for social good.

Financial planners - providers of regulated investment advice to clients

a. Financial planners should clearly identify interested clients through an appropriate discovery questionnaire e.g. by adapting the one presented in this report.

b. Financial planners should understand social investment products and how to advise on their suitability for a client within their overall financial goals. The concept of a 'social investment pot' needs to be established in the procedures and processes of financial planner firms.

c. Financial planners need to adapt their systems to track social investments for clients, including not only financial returns but social impact as well. It will be important to evaluate performance based on a mix of social impact and financial return, linking these back to a client's previously stated goals.

The profession's FSA accredited bodies

d. Accredited bodies should encourage the debate and engage with the regulator to clarify regulations and the changes that are needed.

e. Accredited bodies should make sure that firms are competent to advise in this area by developing training resources as part of a continuous professional development programme, in order to equip financial planners to identify appropriate clients, advise on, track and report on these products.

Social investment intermediaries designing product solutions

f. Social investment intermediaries should initially focus on building relationships with financial planners who are socially motivated, as these will be the most receptive.

g. Products should be kept as readily identifiable as possible with existing classes of investment product. The difference should be confined to the social impact and its effect on return.

h. Financial planners are more likely to include social investments in advice where there is a tax incentive.

i. Financial planners will respond to client demand. Social investment intermediaries should stimulate client demand through direct–to–consumer channels, encouraging them to talk to their financial planner.

j. Product suppliers should generate materials that contain all that could be expected for a similar product promoted to the profession. In addition, it must contain clear case studies and an explanation of the social good that it is intended to achieve and the risks to the expected outcomes.

k. The social investment sector should encourage informative media and seminars to increase the level of understanding of the asset class and specific products.

Regulators, government and other influencing bodies

l. The social investment asset class, due to its early stage of development, lacks the regulatory clarity of other markets. The government and regulators should develop a clear regulatory framework for the market to reach its full potential.

m. While a VCT or EIS investment for financial planners is fine as a vehicle, it is not the appropriate structure to raise capital for all social investment opportunities. Currently, there is not sufficient tax incentive for investing in an activity intended to generate social good. This points to the need for change in the VCT/EIS legal form, so as to make these suitable for a broader range of social investments. There also need to be incentives for lower-risk debt instruments in their own right, with a lower level of tax incentive reflecting the risk and social benefit.

n. A definition of what 'qualifies' as a social investment is required. This would assist the financial planner by providing confidence in the authenticity of the opportunity. A set of boundaries would more easily determine qualification from a regulatory and/or tax perspective if a framework bespoke to social investment is provided.

There is a clear opportunity, through a combination of positively inclined financial planners and relatively wealthy clients, to expand the market in social investment fairly rapidly. This would enable the market to be broadened and to provide more social investment opportunities for individuals with lower levels of wealth.

This report sets out required changes in the behaviours of all stakeholders as well as in the regulatory framework. Some recommendations will take many years to develop and integrate. It will be of interest in three to five years' time to undertake a review of advice relating to social investment products in the UK. Social investment appears to be of its time, but will it become a meaningful way for individuals to deploy their wealth?

Appendix A:

OVERALL RESULTS OF QUANTITATIVE SURVEY

This Appendix contains some extended tables from the survey for completeness.

In the quantitative survey, financial planners were asked about the likelihood of their clients already having an interest in impact investments.

Table A1: Unidentified demand (187 responses)

Do you think you have unidentified demand for impact investments among your clients?	
Answer Options	**Response Per cent**
Definitely not	5.3%
Unlikely	19.8%
Possibly	57.8%
Highly likely	17.1%

Seventy-five per cent of respondents therefore believe that there is possibly/highly likely to be unidentified demand for social investment among their clients.

Financial planners were asked to rank their top three of nine choices of drivers which most influence their decision to recommend impact investment to a client. They could also suggest another reason as well.

Weighting first choice as 3, second choice as 2 and third choice as 1 gives the following weights:

Table A2: Drivers which influence the financial planner to recommend (195 responses)

Which of these drivers would most influence your decision to recommend impact investment to a client?	
Driver	**Weight**
Client demand for impact investing	296
Wanting to do social good	218
Revenue potential for a client from impact investments	177
Adherence to regulatory requirements	133
Improvement of corporate social responsibility (CSR) activity by your business	94
Enhancement of your firm's brand	67
None – not interested in impact investments	45
Post RDR revision of investment strategies	38
Revenue potential for a financial planner practice from impact investments	34

Financial planners were asked what was stopping them offering impact investments to clients. They could tick as many choices as they wanted. The responses were as follows:

Table A3: What stops/might stop financial planners offering 'impact investments' to clients (173 responses)

What stops/might stop you offering 'impact investments' to clients (tick all that apply)?	
Barrier	**% of Financial Planners responding**
Feel they are mostly unregulated collective investment schemes (UCISs)	64.7%
Not enough knowledge	55.5%
Not on a platform	41.6%
Perception that returns are not good enough	41.0%
Social impact not clear	39.9%
No perceived client demand	31.8%
Other	21.4%
Not interested in such products	7.5%

Regulation concerns are the top hindrance, which is considered further ir Section B: 6 Regulatory.

We asked, 'What key developments need to happen to "impact investments" to reach a position of a recognised and well invested asset class (pick top five of following and then rank 1 to 5 by putting a tick in the appropriate column – only 1 tick is allowed in each column. 1 = high, 5 = low)?' They could also suggest another development as well.

Weighting first choice as 5, second choice as 4, etc. gives the following weights:

Table A4: Developments needed to become an Asset Class (163 responses)

What key developments need to happen to 'impact investments' to reach a position of a recognised and well invested asset class?	
Development	**Weight**
Risk clearly defined	339
Covered by the Financial Services Compensation Scheme	315
Track record of financial return	262
Client demand	259
Availability of tax incentives, e.g. enterprise investment scheme	176
Track record of social return	155
Trade–ability of products	146
Accessibility of investment products through market structures e.g. platforms	144
Regulation change e.g. easing UCIS (Unregulated Collective Investment Schemes) regulations for social investments	140
Good reputation of product provider	119
Good reputation of social organisations that are being invested in	110
Availability of products in clearly defined sectors e.g. property, environment, etc. and geographical regions	85
A standard way of measuring social impact across products	74
Grouping of social investment products into one product e.g. a fund of funds	52
Other	22

We asked about attractive product characteristics. This was an optional question so there were only 143 responses. Financial planners were asked to rate these as: Not at all important, Fairly important, Important, Very important or Essential.

Giving scores to these of 0–4 respectively gives the following weights:

Table A5: Product characteristics (optional) (143 responses)

In your view, how would you rate each of the following potential 'impact investment' product features in terms of their importance to a client who is considering an investment?	
Characteristic	**Weight**
Risk is clearly identified	470
Covered by the Financial Services Compensation Scheme	388
Any fixed term nature of investment is clear	380
Availability of professional advice	378
Reputation of product provider	348
Track record of financial return	334
Social impact is independently audited	329
Social need addressed by the investment	327
Liquidity i.e. being able to access their funds easily	320
Track record of social impact	319
Encouraging social good with business efficiency	279
Affordable minimum level of investment	277
Type of investment offered e.g. equity, bond, etc	269
A standard way to measure social impact across products	265
Helping social funding in the current economic climate	261
Spread of investments over several impact product providers	257
Tax incentives attracted by the investment, e.g. Enterprise Investment Scheme	250
Geographical area of the world investment focused on	225
Target financial rate of return (% p.a.)	203

Regular income from investments	175
Part of a new and innovative asset class	143
Fixed returns	135
Other	27

Appendix B:

ANALYSIS OF SURVEY BY IDENTIFICATION WITH SOCIAL GOOD

Please find more results from the quantitative survey as indicated in Section B: 3. Financial planners enabled to 'put something back'.

On a scale of 1–10 (1 low, 10 high), where are you personally in terms of your identification with/ commitment to investing for the benefit of others/societal change i.e. a positive impact in society?

(192 responses)

30 per cent entered 1–3 i.e. low identification.

49 per cent entered 4–7 i.e. not that identified.

21 per cent entered 8–10 i.e. high identification.

Taking the low identification and the high identification groups and comparing their responses to other questions shows a marked difference.

These are analysed below:

Table B1: Drivers based on financial planners personal identification with investing for social good (192 responses)

	Low Identification 1–3	Overall Survey	High Identification 8–10
Question: Which of these drivers would most influence your decision to recommend impact investment to a client (tick top 3 choices)?	1. Client demand for impact investing	1. Client demand for impact investing	1. Wanting to do social good
	2. Revenue potential for a client from Impact Investments	2. Wanting to do social good	2. Client demand for impact investing
	3. Adherence to regulatory requirements	3. Revenue potential for a client from Impact Investments	3. Revenue potential for a client from Impact Investments
	4. None – not interested in impact investments	4. Adherence to regulatory requirements	4. Adherence to regulatory requirements

Drivers influencing the financial planners' decision to recommend impact investment to a client follow the financial planners' personal identification with investing for the benefit of others.

These further confirm the conclusion that the degree of identification with social objectives by the financial planner affects the response to other questions.

Table B2: Other questions

Question	Low Identification 1–3	Overall Survey	High Identification 8–10
Agreement that retail clients should be surveyed about appetite for impact investments. 173 responses	31%	48%	73%
Agreement that retail clients should be advised about social investment options in their investment reviews. 172 responses	35%	49%	79%
Agreement that social investments, if unlisted and illiquid, are still capable of being suitable for retail clients if they are limited to a small percentage of a portfolio of investments. 173 responses	34%	49%	77%
Agreement that UCIS rules should be relaxed to allow retail investors to hold UCIS social investments up to certain prescribed limits. 172 responses	25%	35%	55%
Has your organisation already recommended social or impact investment to a client? 172 responses Not yet and not really interested	39%	21%	9%
Has your organisation already recommended social or impact investment to a client? 172 responses Yes	30%	40%	60%

Appendix C

OVERVIEW OF PRODUCT CONCEPTS

The product concepts that were presented to financial planners for discussion are described below. We fed specific comments about each concept back to the appropriate product provider so that the product design could be improved for the financial planner distribution channel. We have drawn out general comments, however, and those are included in the report.

Concept 1 – Capital plus bond

Capital+ impact bonds work by lending part of the funds invested at a fixed interest rate to an AA-rated 'not-for-dividend' social housing provider. The proportion loaned is calculated such that the return of the loan plus compound interest at the end of the term is equal to the amount required to repay bondholders the capital they have invested.

This leaves a proportion of the funds remaining, from which the bond provider can recover its costs then invest the rest in one of a choice of social impact funds which the investor nominates. The intention is to offer a choice of funds which could be of interest to the investor, e.g. microfinance, social enterprises, etc. These may be higher-risk, depending on the fund choice and returns are variable.

Concept 2 – Impact fund-of-funds

The fund-of-funds enables investors to invest in positive social change through an easily accessible, institutional quality product. It is a $250m target size fund-of-funds seeking to invest in 15-20 of the world's best high social impact debt and private equity funds, targeting significant social impact and attractive financial returns in developing economies. The fund will primarily target five key sectors – sustainable agriculture, financial inclusion, healthcare, micro-cap SMEs and community-based energy – in three geographic regions – Africa, Latin America and Asia.

Concept 3 – Impact VCT

An impact VCT is an eight-year, planned-exit, specialist VCT investing in UK socially driven companies with an articulated and measurable social purpose. The social impact VCT's target investee companies will focus on four areas of social impact: building the futures of people who are marginalised or disadvantaged; community cohesion; fair trade and ethical consumerism; and health and education.

Concept 4 – Green energy bond

The green energy bond is a fixed-term bond offering an ethical fixed-return opportunity for individual and corporate retail investors. Funds invested in the bond will be loaned to a UK charity

to purchase land and install wind turbines in India. The organisation has already successfully managed the installation of two turbines which have been turning since August 2008. The organisation is now looking to scale its operations further with the installation of additional turbines.

Concept 5 – Social impact bond (EIS)

This fund is to improve outcomes for vulnerable 11–16-year-olds based in Essex, who are at risk of going into care due to behavioural problems or family breakdown. The primary objective is to reduce time spent in care by adolescents. Research shows very poor social outcomes for children who have been in care. The fund will pay for a range of support for families in Essex over five years. The more successful the interventions to reduce days spent in care, the more outcome payments Essex local authority will pay. The outcome payments fund the returns to the investors.

Concept 6 – Charitable bond

Charitable bonds are a unique social investment product, offering a low-risk and ethical fixed-return opportunity for individual and corporate retail investors that releases up-front, unrestricted grant funds for their chosen charitable cause. The bonds work by lending part of the funds invested at a fixed interest rate to an AA-rated 'not-for-dividend' social housing provider. The proportion loaned is calculated such that the return of the loan plus compound interest at the end of the term is equal to the amount required to repay bondholders at the rate of return they have selected (currently up to 10 per cent). This leaves a proportion of the funds remaining, from which the bond provider can recover its costs, then give the rest as a grant to the investor's nominated cause.

Observations

As the six product concepts were tested, it became apparent that the products financial planners were comfortable with or liked were those that mirrored the products that they were already used to advising on.

Some 'good' characteristics emerged from the tests, which related specifically to this product set. We have not included these 'characteristics' in the main section on products as a recommendation because financial planners will have mixed preferences for products and their clients' appetite will vary due to financial circumstances, outlook on risk, identification with social cause and/or location.

With the above set, the general 'good' characteristics that were identified are as follows:

- It is better to have shorter-term products. This would be up to five years. Not many clients have a longer-term outlook, and circumstances change.
- There was very little interest in products that did not return the principal invested plus a return. However, that return could be less than a non-social investment.
- Ideally the product should have tax benefits. These suits clients with tax issues.

- Minimum investments should be relatively low – between £10k and £50k. This de–risks the investment somewhat and allows investment to be made into several products to diversify the risk.

- The provider must define how the investor can exit from the investment and, in the case of fixed–term investments, how the principal and any return will be generated.

- Products that addressed UK social issues were more popular than overseas ones.

- In addition to this, we also observed the following issues:

- Closed–end funds that only have limited time windows where investments can be made – the financial planning process is complex and requires time to investigate the product and the provider in order to perform due diligence and then advise client(s). It is an investment in time that is costly and due to client appointment scheduling throughout a year, may not create the capital flows desired due to the time window for investment. This has less effect on products with tax benefits as the busy period for these is in the latter half of a tax year. Product providers must get these products launched by October in any year and these should cover both tax years.

- Small tranche products, i.e. relatively small sized funds – again, the issue is the research effort required for potentially limited opportunity. This time can be spent more profitably by the financial planner.

Appendix D

REGULATING FINANCIAL ADVICE

A 'supervision-based' approach to 'outcomes-focused regulation'

The financial adviser must justify and support their financial planning and investment decisions with rigorous due diligence and a robust process (defending themselves) and ensure that explanations are completely fair, clear and not misleading (protecting their client).

The previous principles-based approach was a move by the Financial Services Authority ('the FSA') from prescriptive rules dictating how firms should run their business to providing high-level guidelines focusing on the desired outcome for the customer. Seen as being 'lighter touch', this approach has now been amended to a more heavily supervised approach partly as a reaction to the change of regulator from the FSA to the Financial Conduct Authority (FCA).

Without wishing to state the obvious, this is an area of significant complexity and importance with many layers. The intention of this section is to provide an overview of the regulated environment for financial advisers.

Layer 1 – various parties and roles

The FSA was granted powers under the Financial Services and Markets Act 2000 (FSMA) to regulate individuals and firms across the main sectors of the financial markets in the UK.

The FSA is to be replaced by two new regulators. In terms of the financial advice market, the new regulator will be the FCA. Initially there is likely to be no difference between the FSA and the FCA in terms of management or staffing. When the FCA takes over, the changes introduced by the Retail Distribution Review (RDR) should almost all be in place. There is likely to be an increase in staffing due to the requirement for increased supervision.

Part of the regulator's responsibility is retail investment activities, which includes the provision of financial advice to retail clients by the financial adviser industry. The changes introduced by the RDR, including a change from commission-based remuneration to fee-based remuneration and a new benchmark qualification set at QCF level 4 should result in this market/industry being perceived more as a profession, although many firms will continue to be transaction based. There are many stakeholders involved in these retail investment activities, identified below:

1. The FSA/FCA (whose role is to authorise and regulate financial firms).

2. The Financial Ombudsman Service (FOS) – the statutory dispute resolution scheme, providing an independent service for resolving consumers' individual complaints about firms.

3. The Financial Services Compensation Scheme (FSCS) – a fund set up under the Financial Services and Markets Act 2000, becoming operational on 1 December 2001. It is independent from the government and the financial industry, although the FSCS is funded by the financial

services industry. Every firm authorised by the FSA is obliged to pay an annual levy, which goes towards the running costs and the compensation payments made.

4. Individual retail investment adviser (which includes financial planners, private bankers, insurance company salesforces and wealth managers).

5. Networks and support providers.

6. Advisory firms.

7. FSA accredited bodies (e.g. Chartered Insurance Institute, the PFS and the Institute of Financial Planning) are subject to FSA oversight in relation to:

   - Their investment adviser members' activities.

   - The duty to supply an independent audit report, both on application and on an annual basis, covering their arrangements for monitoring compliance with set criteria.

   - PS11/1, which sets out the strict criteria that bodies to be accredited must meet, which include:

     - Acting in the public interest and the further development of the profession

     - Carrying out verification services

     - Having appropriate systems and controls in place to provide evidence.

   The criteria for accreditation of these bodies are intended to ensure that there are consistent standards for all advisers. These standards are additional requirements to the responsibility already in place on firms to ensure that advisers are competent. With effect from 1 January 2013, all financial advisers will be required to have a current, i.e. annual, 'statement of professional standing' (SPS). The SPS can only be issued by an accredited body and so these organisations are of growing importance.

Layer 2 – high-level guidelines

Some relevant background to understand the current regulatory environment:

In December 2001, the FSA became the regulator of financial services in the UK. The FSA rulebook was published with 40,000 pages, and with the pace of change in this market it was becoming impractical for a significant number of firms. It was realised that because there is such a variance in firms' business models and practice that a more flexible approach was required.

Five years ago the FSA began the move from a 'rules-based' regulatory regime, to a 'principle-based' approach that leads to outcome-focused regulation (OFR), the intention being that it would lead to a greater expectation and more responsibility on the senior management of the regulated firms themselves to determine best business practice and deliver a well-managed, client-centric proposition. A paper entitled 'Principles-based regulation – Focusing on the outcomes that matter' was issued outlining their key 'principles for business'. In this paper, the FSA set out its strategy for delivering principles-based regulation in the UK.

The FSA has a set of 11 high–level guidelines or 'principles' (Appendix E). These have been in place since 2001 and most were present in the part of the former regulatory system overseen by the Securities and Investments Board. These principles were introduced by the FSA as follows:

> *'Firms will have increased flexibility in how they deliver the outcomes we require. Many will find a closer fit between meeting their business objectives and meeting regulatory requirements. Responsibility for key regulatory decisions will move to more senior levels, challenging firms' compliance, risk management and internal audit functions as they provide the necessary support to senior management and Boards.'*

The 'Treating Customers Fairly' (TCF) initiative came at the start of this change in approach, which was designed to ensure that firms were focused on behaviour that delivers on six consumer outcomes (Appendix F). The FSA is not prescriptive on how these outcomes should be achieved and so the responsibility is placed squarely with the senior management of the firm to find the best way to meet these requirements. Firms must be able to demonstrate that they have processes that ensure that TCF principles are at the core of their processes.

Layer 3 – detailed rules underpinning the 'Principles' – guidance material

Under the overarching umbrella of the 'Principles' is the FSA Handbook which contains more detail, as the principles need to be underpinned with rules. However, with the move to more principles–based regulation, there are fewer rules underneath the principles.

> *'Like the Principles, these rules will not focus on a specific process that a firm should undertake, but an end point that should be achieved.'*[12]

In addition, rules will also be required for the implementation of European Directives. An example is the Markets in Financial Instruments Directive (MiFID) which was designed to ensure a single EU market in investment services. This directive was used by the FSA to rewrite the Conduct of Business (COB) rules as to the delivery of advice, e.g. suitability and appropriateness of products. There are also the standards for financial promotions which were already in place.

Layer 4 – published informal supporting material: case studies or 'Dear CEO' letters

The FSA also publishes material and other informal supporting material. As an example, there is a series of various factsheets, one of which is 'FSA factsheet for financial advisers – suitability reports'. It forms part of the 'regulatory toolkit'. A firm can use this to review their practice, process and conduct, to consider if any improvements are required. This information is designed to help firms help themselves and it reflects information that the FSA has found at firms demonstrating what appears to the FSA to be 'good practice'.

A significant number of comments from respondents contributing to the research have reflected the uncertainty created by what appear to be retrospective actions by the FSA. This is eloquently summarised in a paper on the subject of regulation by SIFA which says: *'The downside of introducing flexibility is that it is necessarily accompanied by subjectivity, which, to make matters worse, is often exercised retrospectively.'*[13]

> *'With principles–based regulation, firms are encouraged to exercise their own judgment and make their own decisions about what is needed to comply with a rule or principle. However, this places greater responsibility for firms and in particular senior management to ensure that firms have the appropriate culture, systems and controls to achieve the right outcomes.'*[14]

In 2010, in reaction to the financial crisis, the FSA began a new approach: outcomes–based supervision. Firms are still left to operate within the Principles but the regulator has become more proactive and interventionist. They are increasingly prepared to make judgement calls that particular structures and products may cause poor consumer outcomes rather than acting after those outcomes have come to pass.

It is clear that adviser firms are finding it harder to predict how the FSA may react to their business processes and conduct. There are fewer certainties and significant discomfort in the current environment. This all puts a greater emphasis on senior management to manage regulatory and commercial risk in their business, which is a stated regulatory intention. Many firms are compensating for this by turning to specialist compliance providers who help them decide how to meet the expectations of the FSA. It is particularly smaller firms that experience difficulties with principles–based regulation, which has led to further growth in the network and support provider sector.

The RDR process has added considerable uncertainty to advisory firms, specifically around business models and the range of products on which firms wish to provide advice.

Layer 5 – business process

Two further requirements for firms authorised by the FSA are relevant to mention at this point: professional indemnity insurance (PII) and compliance oversight. A financial planning firm is required to have a regulated PII contract which, within certain limits, covers the business in the event that a third party claims to have suffered a loss as a result of professional negligence. As with any insurance contract, the premium is evaluated based on the risk to the insurer specific to each individual business covered. Consideration is given to the client firm's level of turnover, the type of business they write and their claims history. This is inextricably correlated to a financial planner's own compliance procedure and monitoring, which meets the requirements of one of the Principles and effectively provides another level of licensing. In theory, the more robust the compliance process, the greater is the opportunity to manage risk out of the business. The compliance function of a financial planning firm may have its own internal licensing process restricting the advice that can be given by certain individuals with the relevant skills and qualifications for certain types of advice or products.

Layer 6 – product

Products may be regulated or unregulated. 'Pooled funds' or collective investment schemes (CIS) are popular investment structures in the UK. The FSA will either authorise a CIS (known as a 'regulated CIS') or, for a non–UK CIS, it can recognise whether certain criteria are met and therefore it can be marketed in the UK with certain restrictions. If the FSA does not authorise or recognise a CIS, it is therefore an unregulated CIS or UCIS. A UCIS may be established, operated and/or managed in the UK or in a jurisdiction outside the UK.

There are various rules in the 'Conduct of Business Sourcebook' (COBS) concerning UCIS specifically. From breaches cited in 2011, there are concerns from the FSA related to the advice process in three main areas:

1. **Promotion – consideration of whether a client is eligible.**

2. **Suitability – inadequate quality of advice or suitability.**

3. **Risk management and oversight – above two failures are a symptom of poor risk management and oversight.**

Investors in UCIS products in the event of their failure will have no right to complain to the FOS and will not be covered by the protection of the FSCS.

In such circumstances, the only option available to the investor would be to complain to the financial planner who recommended the initial investment, on the grounds that it was not suitable for their needs, or that the financial planner and/or the scheme manager breached other regulatory principles. As the scheme manager is often not UK–based, the financial planner (as promoter) is the most logical target for such complaints. The financial planner may need to revert to their PII and make a claim on their policy (if covered, some will specifically exclude UCIS business). If it is proved in a court of law that there is a breach in any of the Principles, promotion, distribution, suitability, or the MiFID rules, it will call into question whether the PII will pay out. The following statement from the FSA captures the high level of uncertainty for the financial planner that becomes involved in a regulatory breach.

> *'Our overall objective is to help firms make decisions themselves about what business processes and controls they should have in order to meet our requirements. In considering a firm's response to an investigation or other regulatory action we may look to material we have issued. The status afforded to our materials may impact the weight they carry in an enforcement context.'*[15]

Appendix E

PRINCIPLES FOR BUSINESS

The principles for regulation set out in simple terms the high–level standards that firms should apply:

1. **Integrity –** A firm must conduct its business with integrity.

2. **Skill, care and diligence –** A firm must conduct its business with due skill, care and diligence.

3. **Management and control –** A firm must take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems.

4. **Financial prudence –** A firm must maintain adequate financial resources.

5. **Market conduct –** A firm must observe proper standards of market conduct.

6. **Customers' interests –** A firm must pay due regard to the interests of its customers and treat them fairly.

7. **Communications with clients –** A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.

8. **Conflicts of interest –** A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

9. **Customers: relationships of trust –** A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.

10. **Clients' assets –** A firm must arrange adequate protection for clients' assets when it is responsible for them.

11. **Relations with regulators –** A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Appendix F

TREATING CUSTOMERS FAIRLY (TCF)

Your responsibility is to ensure that your firm treats your customers fairly and that a TCF culture is fully embedded throughout your firm.

Because of the wide range of activities and business models you carry out, it isn't possible to outline TCF in a way that applies to everyone. We allow you flexibility in deciding how best to meet our requirements.

To be assessed as successfully treating your customers fairly, you need management information which demonstrates the following six outcomes for your customers:

1. **They are confident your firm has put fair treatment of customers at the heart of your corporate culture.**

2. **You sell and market products and services designed to meet their needs.**

3. **You give them clear information and keep them appropriately informed before, during and after the point of sale.**

4. **You give them suitable advice which takes account of their circumstances.**

5. **You provide them with products which perform as you have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect.**

6. **You do not impose unreasonable barriers after a sale when they want to change product, switch provider, submit a claim or make a complaint.**

Online information:

Visit the TCF section of our website: **www.fsa.gov.uk/smallfirms/tcf**[16]

Appendix G

YOUR LOGO HERE

Factfinder/Discovery questionnaire

The purpose of the following questions is to obtain from clients sufficient information to identify whether they could be
approached with opportunities to deploy their wealth in social investments.

Social Investments are *investments intended to create positive social impact beyond financial return*:[10]

- Providing capital
- Expecting financial return
- Business designed with intent (fund managers or companies)
- To generate positive social and/or environmental impact

Business sectors:

Basic needs: agriculture, water, housing

Basic services: education, health, energy, financial services

Investment instruments: debt, equity, social impact bonds (not a bond!) – returns may be linked to metrics of social performance such as preventing children on the edge of care falling into care.

Q1. Background for the adviser. From previous research among high net worth individuals into the motivations behind a wealthy individual becoming a social investor, we know that there is a correlation between the level of agreement with the three statements below and the likelihood of engagement with social investment. The most statistically significant questions for a financial planner to establish which of their clients will be most receptive to this investment opportunity are the following statements:

Ask the client whether they either:

1. Strongly agree ☐ **2. Tend to agree** ☐ **3. Neither agree or disagree** ☐ **4. Tend to disagree** ☐ **5. Disagree** ☐

1. When investing, I would like my money to do some good as well as provide me with a return. ☐

2. My investment portfolio reflects my ethical values ☐

3. I like to be actively involved in local community activities ☐

If there is agreement with any of these statements, then ask the following four questions:

Q2. Are there any areas of social good that may interest you? (The list below is not exhaustive – tick all that apply.)

Microfinance (small loans to individuals so that they can start to trade) ☐	Employment opportunities (e.g. homeless, disabled people, youth, etc.) ☐	Young people (e.g. education, children in care, skills training, etc.) ☐
Social housing or regeneration ☐	Environmental (e.g. renewable energy, forestry) ☐	Rehabilitation, e.g. working with ex–offenders, addicts ☐
Rehabilitation, e.g. working with ex–offenders, addicts ☐	Local community projects ☐	Ethical consumerism (e.g. Fairtrade) ☐
		Other (please specify) ☐

Q3. Are there any areas of social good which are of particular interest or that you particularly identify with?

Q4. Are there any areas of the world that you are interested in influencing (tick all that apply)?

Area of UK (specify) .....

Americas ☐ UK ☐ Asia ☐ Europe ☐ Australasia ☐ Africa ☐ Middle East ☐ Other (specific regions or countries) ☐

Q5. Social/community investments may not give the same financial returns as 'traditional' investments. To what extent are you willing to sacrifice some financial return for achieving social good?

A. Lower income compared to a similar conventional investment ☐
B. No income – all used by social enterprise ☐
C. Potential loss of capital ☐

Endnotes

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