Chris Barnard

Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
United States
www.sec.gov

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- File No. 4-645
- Comment Request for Study Regarding Financial Literacy Among Investors

Dear Sir.

Thank you for giving us the opportunity to respond to your request for comment for Study Regarding Financial Literacy Among Investors.

In connection with a study regarding financial literacy among investors as mandated by Section 917 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), you are requesting public comment on the following:

- methods to improve the timing, content, and format of disclosures to investors with respect to financial intermediaries, investment products, and investment services;
- the most useful and understandable relevant information that retail investors need to make informed financial decisions before engaging a financial intermediary or purchasing an investment product or service that is typically sold to retail investors, including shares of registered open-end investment companies (mutual funds); and
- methods to increase the transparency of expenses and conflicts of interests in transactions involving investment services and products, including shares of mutual funds.

When I went to school I learned everything from finger painting to Fibonacci numbers, but I was rarely taught important practical topics. For example about simple financial matters: what is an interest rate; how does banking work; what is the role of private insurance in society; what is a pension, how does it work and is it important; the importance of distinguishing between real and nominal numbers and changes thereon; what is a mortgage; how does a loan work; what are stocks; how does the economy work; and what does a business do in simple practical, real, economic and accounting terms. I learned all of these issues and much more through specialised tertiary education courses, and through professional training (and work) thereafter. But you would be amazed at the general lack of financial awareness, understanding and literacy in great swathes of the population.[1] This is an important example of where education could make a real difference to people's understanding of finance, economics and business, which is a much more important feature of peoples' lives than learning the names of kings and queens, or how an ox-bow lake forms.[2] Given this general lack of financial literacy in the population, we must be careful that any information provided to investors is jargon-free, clear, comparable and not misleading and clearly answers the pertinent questions concerning the investment's potential risks and reward, and value-for-money. The vital issue here is to better manage the expectations of investors in this regard.

Basic investment information

Documents that communicate the key features of the investment (Key Features Documents / Key Facts etc) are becoming more common. Such documents usually contain:

- the name / description of the company offering the investment
- a description of the investment and its benefits
- eligibility conditions
- details on investment limits and payment methods
- a description of any guarantees
- withdrawal features
- fund / investment choices

Further information may be given about:

- the risk factors associated with the investment and funds
- any tax advantages or tax reliefs associated with the product and its payments in the particular market
- charges and deductions (types and how levied)
- early encashment values
- the liability of the company offering the investment in relation to guarantees

There is quite some variation in the amount of information provided in these documents, which can range from a couple of pages to over 20 pages in length.

A key features document provides a single, concise document containing all of the key information about the product and benefits, and its investments. It is a softer document than the contractual terms and conditions for example, and is certainly more understandable to

[1] For example see: http://www.dfi.wa.gov/consumers/financial_literacy_stats.htm
http://www.forbes.com/2010/01/12/cfpa-financial-illiteracy-credit-cards-opinions-columnists-thomas-f-cooley.html
http://money.usnews.com/money/personal-finance/articles/2008/04/02/financial-literacy-101

[2] The financial education website MyMoney.gov is a good starting place for financial education, but this can only realistically supplement people's basic understanding of financial matters.

investors. This helps to manage the investor's expectations regarding the product and how the product will fulfil the investor's needs, and the investment's risk and reward profile, and can be a useful tool to reduce potential misselling.

Frequently asked questions (FAQ) by definition aim to answer the most commonly asked questions in a single, controllable format (control is important here). This provides a basic level of understanding and information to a potential investor before going into more detail during later stages of the selling / distribution process.

Regarding the ongoing and regular provision of information, I would recommend that an investment company should normally send the investor a statement once a year containing information about the current value of the investment. The investor should be able to contact the investment company or financial intermediary to obtain further information. Information on funds' performance should be distributed in various media, for example a national newspaper or the internet. Finally, some investment companies offer a "calculator" on their website which provides some additional information / calculation on potential performance.

Illustrations of potential payouts

Illustrations help to manage investor expectations regarding potential payouts by showing a reasonable range of potential payouts, including unfavourable ones. This is an important topic, as illustrations of potential payout are often a key decision factor for investors, which can also create expectations. (Illustrations may therefore provide a certain level of protection against mismanaging expectations during the selling process.) This should help to reduce misselling. As a minimum, investment providers should be required to present three potential scenarios; e.g. unfavourable, medium (or most likely or best estimate) and favourable. Within these a balance needs to be struck between risk and reward. It is paramount that those scenarios presented do not mismanage investors' expectations, or unfairly distort their perception of the various investment options available.

I would recommend one of the following two options to allow for different asset allocations:[3]

- 1) the three scenarios could be chosen from a stochastic set, which would allow explicitly for the expected risk and return profiles of the different assets in its parameter settings and calibration. E.g. 1000 such scenarios could be created, and the mean (middle) scenario could be disclosed along with the 25th and 975th best scenarios after ranking.
- 2) The three scenarios could be run deterministically. A risk premium could be included for equity-oriented investment options within the three deterministic scenarios, but also a wider spread of outcomes, which would thus explicitly illustrate the greater expected range of returns for equity-oriented investment options. This could then fairly illustrate the greater risk and reward profile for equity-oriented investment options.

[3] E.g. Govt bonds, corporate bonds, stocks, hybrid, property, cash, structures all have different risk / reward profiles. But there is no free lunch: one cannot simply invest in stocks and expect high returns forever without also expecting greater risk and volatility in the returns.

Either of the above options would fairly and reasonably manage expectations concerning the relative risk / reward profiles for different investment options.

Perhaps a "worst-case" scenario should also be presented, which would show the minimum possible payout to customers (not including default of the provider). All of this information at point of sale would be more effective than a standard wording such as "the value of your investments may go down as well as up".

Scenarios should always include the effect of all charges on the potential payouts. This will help investors to compare and contrast different investments and providers, and to make value-for-money judgements thereon. If charges are ignored, then this will only encourage investment providers and investment companies to increase charges, as their effect would be excluded from illustrations. If not all the charges are included, then investment providers will simply shift the charges accordingly, which would be intransparent and to the detriment of investors. A useful method of showing the effect of all charges on potential payouts is to disclose the reduction in the assumed illustration yields due to those charges. This provides one fairly simple and understandable metric to help investors make investment comparisons and also make value-for-money judgements.[4]

Information about financial intermediaries[5]

Investors should be fully informed about the status of any financial intermediary involved in the distribution of the investment to the investor. In particular, investors should know from the start if the intermediary is independent or tied; how much variable remuneration (e.g. commission or fee) will the intermediary receive for the completed sale; and who will pay this remuneration. It is very important that this information is timely, clear and not misleading, so that (ideally) the investor could make an informed judgement about the financial intermediary's conflict of interest in the sale.[6]

A conflict of interest arises when a financial intermediary's obligation to act in the best interest of the investor conflicts with any of:

- the intermediary's own interest
- an interest of the investment company
- the interests of third parties including other investors

Effective guidance on conflicts of interest should be introduced, including a general principle that financial intermediaries must ensure that their ability to provide objective advice is not, and cannot be perceived to be, compromised. This would even include advising not to buy an investment company product, if appropriate. It is the intermediary's responsibility to ensure

[4] For more information on the benefits of regulation in this area, including on the effect of charges and the reduction in yield, please refer to: http://www.fsa.gov.uk/pubs/other/cra_report_benefits.pdf

[5] I want to briefly add that financial intermediaries should be trained properly on the investments, products and services that they offer, and should demonstrate an appropriate level of knowledge. Selling practices should also be reviewed regularly.

[6] Although the onus should be on the financial intermediary to disclose any conflicts of interest to the investor.

that it is aware of any existing or potential conflicts of interest, and that these are disclosed up-front and documented, or else the intermediary should disqualify itself from acting in the particular case.

Summary

I started my comments by highlighting the general lack of financial literacy in the general population, which should ideally be remedied during education from an early age. Investors today should be given clear, jargon-free and not misleading information about any investment or potential investment. Key features documents and frequently asked questions are very useful in this regard. Investors should also be given a reasonable range of illustrations of potential payouts at point of sale, in order to better manage the expectations of investors. This will certainly help to reduce the risk of misselling going forward. Finally, investors should be made aware from the very start of the status of any financial intermediary involved in the distribution of the investment to the investor, and any (potential) conflicts of interest in the sale. All of these steps will increase transparency, tackle the asymmetry of information between investors and investment providers, improve understanding of investments and enable better comparison between different investment options. This will promote confidence in investing, and in the financial services industry generally.

Yours faithfully

C.R.B.

Chris Barnard