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A legal update from Dechert's Financial Services Group

Product Intervention

The Financial Services Authority (the "FSA") published in late January this year a discussion paper (DP11/1) which contained a Foreword—unusually written by its Chairman Lord Adair Taylor—considering how the FSA (and its proposed successor body) will pursue its consumer protection objective and strategy. DP11/1 set out the FSA's rationale for product intervention, and noted some related EU developments. The immediate reaction of some industry associations—for example, the Association of British Insurers (the "ABI")—was to state that it opposed the development of new product intervention powers for the FSA and believed that the FSA should instead focus on a more effective, proactive and consistent use of its existing supervisory and enforcement rules.

In this *DechertOnPoint*, we analyse the FSA's proposals, related EU developments and the industry reactions to date.

Introduction

The FSA published on 25 January 2011 a discussion paper on product intervention (DP11/1) considering how the FSA and its successor body will pursue its consumer protection objective and strategy. The paper sets out options for possible new requirements (to be considered in more detail in the future) which will help to shape the new authority's regulatory philosophy.

The FSA's main proposals covered:

- **More prescriptive rules.** The FSA proposes to introduce greater prescription in the current regulatory framework to help improve customer outcomes and strengthen its ability to hold firms to account for product governance failings, which may include, for example, upgrading some of the FSA's regulatory guide on the responsibilities of providers and distributors into rules in future.

- **Additional product intervention powers.** The FSA outlined the potential intervention options which could be adopted where it identifies products with features that have the potential to cause detriment to consumers, or that have potential to cause detriment due to firms' flawed governance and distribution strategies, including product pre-approval, the banning of products, mandating product features, price intervention, increasing prudential requirements on providers, consumer and industry warnings, preventing non-advised sales and additional competence requirements for advisers.

The deadline for responses to DP11/1 was 21 April 2011. Responses to DP11/1 will inform the papers which the FSA intends to publish during the first half of 2011 on its approach to the transition to regulation by the new authority, the Financial Conduct Authority (the "new Authority").

Timing

DP11/1 was timed in order to contribute to the Government's thinking, and the public debate

concerning, the balance to be achieved in the area of financial services between consumer protection and consumer choice, and between effective regulation to prevent consumer detriment and the additional costs that this will impose on the industry.

In a speech given in December 2010, Hector Sants, then the FSA's Chief Executive, indicated that the new Authority will be given wider powers to enable it to be more proactive and more transparent than the FSA in preventing consumer detriment in order to allow it to build on the FSA's shift in regulatory philosophy towards an increasingly intrusive, interventionist and judgment-based approach to supervision which the FSA had announced in March 2010.

The FSA has also now made it clear that its proposals are not intended to create a "zero failure" regime where consumer detriment is impossible, but to reduce the frequency with which large-scale market problems occur and, if possible, to stop them from happening at all.

Earlier Regulatory Interventions

Key to the FSA's approach is earlier regulatory intervention in the product chain and engaging with firms to ensure that new products actually service the needs of the customers to whom they are marketed. This approach involved the regulator looking in more detail at how firms design products and at their ongoing governance procedures to ensure that products function as intended and reach the right customers. It also reflects the move in regulatory focus away from the point-of-sale (which relied on fair sales processes, financial promotions and transparent product feature disclosure to achieve the right customer outcomes).

Introducing Specific Product Interventions

As indicated above, the FSA now proposes to introduce greater prescription in the current regulatory framework to help improve customer outcomes and strengthen its ability to hold firms to account for product governance failings. Among other things, this could involve turning some of the current FSA's regulatory guide on the responsibilities of providers and distributors for the fair treatment of customers into rules and, if appropriate, adding to them, with further high-level rules as well as more detailed requirements and bringing together all the rules and guidance on product governance into one place in the FSA's Handbook of Rules and Guidance.

The FSA also outlined in DP11/1 the potential intervention options which could be adopted where it identifies products with features that have the potential to cause detriment to consumers, or that have potential to cause detriment due to firms' flawed governance and distribution strategies, which include product pre-approval, the banning of products, mandating product features, price intervention, increasing prudential requirements on providers, consumer and industry warnings, preventing non-advised sales and additional competence requirements for advisers. However, the FSA is of the view that significant further analysis and debate is required before determining whether these interventions should be part of the regulatory toolkit, although it has indicated that its current thinking is that all of the options should be considered with the exception, at present, of the FSA becoming a pre-approver of all products. Yet, in relation to such products as authorised unit trusts (and now also OEICs) the FSA appears to forget that it, and its predecessor regulatory bodies, have exercised that role in effect since the former Prevention of Fraud (Investments) Act 1958 was enacted and used these powers to control management charges. Arguably, for example, the new price intervention powers the FSA is considering could be used to reduce the level of charges made by hedge fund managers in future, if these were considered to be excessive.

Scope of Product Intervention

The discussion in DP11/1 relates to a broad range of financial products used by retail customers including deposits, insurance products and mortgages. However, the FSA also raises the question of whether similar forms of intervention should be introduced in the governance of services (such as platforms and discretionary management services). The FSA recognises that it would be necessary to adopt different approaches for different sectors to take account of market differences. It also recognises that it may be necessary to treat consumers differently depending on their level of financial sophistication. However, it does not appear to recognise that in many of the leading mis-selling debacles of the past, there has been as much mis-buying of products by consumers exercising their own choices as actual mis-selling of products by product providers and intermediaries. Nor does the FSA appear to recognise that when criticising the industry, after the global financial crisis, for

producing "socially worthless" financial products, its own policy of investor protection is in large measure aimed at the somewhat morally flawed notion of simply protecting consumers from the consequences of their own greed.

EU Developments

The European Commission is also considering further work in the area of product governance. This has surfaced already in the Commission's review of the Markets in Financial Instruments Directive (2004/39EC) ("MiFID"). Specifically, the review contains proposed new organisational requirements for the launch of products and services. The new European Supervisory Authorities ("ESAs") will also have increasingly important roles relating to consumer protection oversight.

Related Developments

The FSA will also take into account other ongoing FSA workstreams which may impact on its product intervention work (such as the retail distribution review ("RDR")), and the Government's proposals earlier this year on simple products, as well as the FSA's former work on consumer responsibility and the Financial Service Consumer Panel's research into "safer" products.

Trade association responses to DP11/1

- **The Association of Private Client Investment Managers (''APCIMS').** APCIMS has been broadly supportive of the FSA's initiative and, in particular, welcomed the possible use of FSA powers to limit distribution of "bad products" regardless of their country of origin. However, it was concerned that an interventionist approach may compromise innovation. APCIMS also opposes any blanket prohibition of non-advised sales and suggests that the FSA should clarify its approach towards exchange-traded products. If the FSA does adopt a more interventionist approach, APCIMS believes guidance should be provided on issues including complexity, product design, product governance and distribution models.

- **The Building Societies Association (the ''BSA'').** Although the BSA supports the FSA's aim of intervening earlier in the product chain to anticipate consumer detriment, its view is that the FSA already has sufficient powers for these purposes. The BSA believes that the impact of the FSA's current intrusive supervisory approach should be properly assessed before new product intervention powers are introduced. The BSA also opposes the introduction of more prescriptive rules on product development and would prefer to see the use of high level principles and rules coupled with detailed guidance.

- **The British Bankers' Association (the ''BBA'').** Many of the points raised by the BSA are also made in the BBA's response. The BBA believes that the FSA should use specific product intervention regulatory tools, such as product banning tools, only as a last resort, and that the focus of product intervention activity should be the protection of retail customers. The BBA also suggests that the Government should consider requiring the FSA and its successor, the Financial Conduct Authority, to act quickly in response to industry whistle-blowing reports that point towards conduct failures in future.

As already indicated earlier in this article the ABI stated in no uncertain terms that it is opposed to the development of new product intervention powers for the FSA.

From the standpoint of the readers of this OnPoint, the response published on 3 May 2011 from the Investment Management Association (the "IMA") on DP11/1 is of particular interest.

Whilst the IMA welcomes the concept of product intervention in the FSA's regulatory armoury, it is concerned that the FSA should not be distracted from the proper and rigorous supervision of distribution or from identifying and applying appropriate sanctions to incidents of mis-selling. In particular, the IMA is concerned that the proposals in DP11/1 would not have identified or prevented a number of the more egregious recent mis-selling incidents, such as Keydata and PacCom, as those products were based offshore.

The IMA's response also highlights a number of further points including the following:

- the IMA is concerned that insufficient account has been taken of the work carried out by the FSA and industry through the treating customers fairly ("TCF") initiative, and in particular, it draws attention to the guidance already issued by the FSA to managers of UK collective investment schemes on product design and the identification of target markets;

- the IMA would expect the increased professionalism and competence levels required by the rules contained in the Retail

Distribution Review ("RDR") over time to result in greater scrutiny of products by advisers;

- the FSA should avoid creating a situation where the process of product intervention results in the stifling of competition and a lack of innovation in the development of new products; and

- market practitioners are often able to identify cases of consumer detriment through their knowledge and experience or will observe and comment on concerns they have with products, and therefore the FSA should consider a mechanism whereby such early warnings can be received without going through the formality of a prescribed whistle-blowing mechanism.

The prevention of product innovation by increased intervention powers is of particular concern in the investment management and funds industry where so many products are seemingly the same and relatively few out-perform published indices. The risk is perhaps of less concern in the banking industry, where former US Treasury Secretary Paul Volker, has pointed out there have been few product innovations of any real value in recent decades, apart from the ATM.

Finally, *The Joint Associations Committee on Retail Structured Products* (the "JAC") published a response dated 21 April 2011 to DP11/1. (The JAC is sponsored by multiple organisations including the Association for Financial Markets in Europe, the International Capital Market Association, the Futures and Options Association and the International Swaps and Derivatives Association).

The JAC made a number of useful comments, including the following:

- although the focus of DP11/1 is on earlier intervention in product design before point of sale, the role of the distributor is fundamental to the consumer protection objective: ultimately it is for the distributor to determine whether a product is suitable or appropriate for an end investor, following the product provider's general assessment of the product against the target market; and

- the JAC does not disagree, in principle, with the proposal to turn some of the FSA's regulatory guide on the responsibilities of product providers and distributors into rules and consolidate existing rules into a single section of the FSA Handbook.

The JAC also responds to a number of the specific proposals in DP11/1, including:

- the applicable regulatory regime should be calibrated to the sophistication of clients and it is therefore appropriate for the proposals in DP11/1 to apply to retail clients only (and not extend to the wholesale market and to professional clients);

- it will be necessary to carry out an extremely careful analysis before a proposal to ban a product is effected and any such power would need to be used proportionately;

- the potential for consumer detriment arises in relation to pricing where a product and its documentation does not reflect the product's time/value, i.e., the product does not reflect its value across its lifetime: the FSA (or FCA) should not necessarily become involved in the pricing of products;

- the specific characteristics of each product need to be considered, including the product documentation and information set out for investors, before the publication of a warning about a group of products takes place; and

- the FSA's proposal that the FSA (or FCA) may direct advised sales only of certain products would result in restricted choice for a consumer where there is demand for the non-advised sales of the type of products concerned.

Conclusion

The FSA's discussion paper on product intervention contains some quite radical ideas, in particular pre-approval, banning products and price intervention. The FSA has in the past steered away from all these types of intervention, but the fact that these notions are being raised is a clear indicator of the more interventionist approach that may be expected from the new Financial Conduct Authority.

What sort of products does the FSA really have in its sights? Probably packaged products or those with opaque structures, and products with complex charging or return structures we think.

Although DP11/1 was only a discussion paper, it should be noted that in a speech on product intervention, Sheila Nicoll, the FSA's Director of Conduct Policy, has said:

> "We are also asking in the discussion paper whether we should consider introducing

> more prescriptive rules in relation to product governance. We think we probably should. This more interventionist approach is in line with European developments, as the FSA recognises".

As the European Commission's consultation on the review of MiFID has already considered organisational requirements for the launch of products, and discusses the possibility of banning specific products or activities, it seems likely that the new Financial Conduct Authority will have its hands largely tied in this area by Brussels and by the new European Supervisory Authorities in future.

Whether the new Financial Consumer Authority in the UK will be up to the task envisaged for it in DP11/1, given the FSA's failures to act on a timely basis in relation to product mis-selling in the past, remains an open question.

As regards the more controversial product banning proposal, the threat is definitely now there. However, as other commentators have pointed out, the concept of a product ban raises interesting questions about precisely where the FSA sees the limits to these powers. The European Commission, in its MiFID Review consultation, envisaged that national regulators might ban products in exceptional adverse circumstances which constitute a serious threat to financial stability or to market confidence only. The FSA may seek to gold plate the scope of these powers.

In reality, the power to ban a product is tantamount to a power to regulate it. Authority for such discretion should be enacted in primary legislation in our view if its exercise is not to become the subject of frequent judicial review proceedings. Does the FSA purport to have the powers to implement such a ban itself, or is this a power that would need to be granted by the legislature? The FSA has not addressed that question at all in DP11/1.

Any such power will give the FSA broad discretionary power. Precisely which products will the FSA choose to ban and how would any product developer genuinely be able to predict what may or may not incur FSA intervention?

The FSA's discussion paper elsewhere sets out a table of indicators of problematic product features, but these are neither exhaustive, and nor are any of them necessarily determinative of what is a bad product. Whilst the FSA feels the need to be prescriptive, it also recognises the limitations of that approach—indeed it may be impossible to define bad products in any comprehensive and meaningful way. Different products have different uses for different people.

Although the FSA acknowledges there are drawbacks involved in banning products, one important point it fails to consider is the effect on consumers' ability to liquidate their positions in any subsequently banned products.

In short, the power to ban (and indeed, any requirement to pre-approve) any product will give the FSA's successor very broad discretionary powers, and both the industry and consumers would need to assume that the Authority would be proportionate in their use of such powers. On previous form, this seems unlikely however. Whilst some of these new tools proposed by the FSA raise interesting legal questions, in light of the ongoing popular (but misguided) desire to rein in the UK's financial services industry, aided and abetted by a Coalition Government in the UK which fails to understand many of the advantages of the industry to the UK's economy (not the least of which is its tax contribution) read with the FSA's rather heated rhetoric, it seems that even the more extreme measures canvassed in DP11/1 cannot easily be dismissed.

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