MORRISON | FOERSTER

News Bulletin

March 14, 2011

FSA Product Intervention

As the UK's Financial Services Authority (FSA) itself would agree, its January 2011 Discussion Paper[1] on product intervention signals a sea-change in the way retail financial products will be regulated in the UK. The proposed new approach outlined in the Discussion Paper involves the FSA (and, in the future, the yet-to-be created Financial Conduct Authority (FCA)) having the ability to intervene at a much earlier stage in the process of designing, creating and selling a financial product, rather than concentrating only on point-of-sale processes and disclosure.

The FSA considers that its existing regulatory approach has not always achieved the right customer outcomes and that in some cases consumers have suffered losses due to breaches of the FSA's Principles for Businesses and other rules. In the Discussion Paper, the FSA highlights three high-profile examples of where it considers the current regulatory approach has failed to adequately protect consumers in the UK – notably broker funds (where broker fund advisers took on a dual role of adviser to the retail investor and investment adviser/manager for the fund itself), structured capital-at-risk products (products whose terms provided that investors, in some circumstances, would not be entitled to the full return on their investments, which in some cases were sold to investors, such as retirees, who could not afford to lose capital) and self-certification mortgages. It is notable that, in seeking to set out justifications for a more intrusive style of regulation, the FSA has used these examples – two of which occurred prior to the arrival of the European point-of-sale directives designed to protect consumers, such as the Markets in Financial Instruments Directive (MiFID) and the Prospectus Directive, and the third of which (self-certification mortgages) does not represent an example of consumer detriment due to an inappropriate product (a self-certification mortgage providing the same set of rights and obligations for the retail customer as other mortgages), but instead due to the mortgage provider not taking on responsibility for protecting the customers from themselves.

Nevertheless, justified or not, the UK government has clearly mandated the FSA, and the new FCA, to adopt a more interventionist and intrusive standpoint in its regulation of retail products, so we look at the proposals in more detail below.

Scope

The proposals cover a broad range of financial *products* which are sold to retail consumers, such as deposits, insurance products, investment products and mortgages. However, the FSA questions whether similar forms of intervention should also be introduced for financial *services*, such as platforms and discretionary management

[1] FSA discussion paper (DP11/1): Product Intervention (25 January 2011), http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf (comments deadline: 21 April 2011). *See also* FSA press release: FSA opens public debate on product intervention (25 January 2011), http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/011.shtml.

services. The FSA recognises that different approaches should be adopted for different sectors to take account of market specificities as well as the varying levels of financial sophistication among consumers.

The FSA also acknowledges that some aspects of the work may more appropriately be addressed at the EU level. For example, the EU Commission consultation on the review of the MiFID envisages empowering supervisory authorities to be more intrusive and to ban certain investment products or activities, and the FSA is envisaging that the responses it receives to its Discussion Paper should inform its stance in its discussions on the MiFID review.[2]

Rationale for Product Intervention

Notwithstanding the existing regulatory safeguards, the FSA considers that some retail financial services markets suffer from weaknesses, such as the fact that consumers may lack some relevant information about a product or, perhaps more commonly, have access to the relevant information but do not use it, or circumstances where consumers are obstructed from making accurate judgments about the price or quality of products. It is concerned that these weaknesses can be exploited by certain products or practices and this concern is aggravated in situations where the product distribution incentives are not aligned with the interests of consumers. In this last regard, the FSA has already published rules[3] banning the payment of commission for advised sales of investments, which will come into effect at the end of 2012.

Therefore the FSA intends to intervene more often before detriment occurs. This is necessarily going to involve the FSA making a judgment as to where problems are more likely to occur and it has suggested a list of features that it considers are more likely to indicate potential "problem" products at an early stage.

At the top of this list are complex products (by which the FSA means "bundled" products or those with opaque structures). In this regard, there may be significant overlap between the products which fall within this category according to the FSA and those that fall within the scope of the EU Commission's Consultation on Packaged Retail Investment Products (PRIPs).[4] The FSA has, however, provided no indication so far that PRIPs will be treated differently from other complex or bundled products, even if/when they become subject to the forthcoming PRIPs EU regime, which is intended to refine and harmonise product disclosure and business conduct obligations in relation to different types of PRIPs.

Other items on the list of potentially problematic features include circumstances where the purchase decision is secondary to another purchase or the product cross-subsidises other products or where the product carries inherent conflicts of interest or contains multiple layers of charging due to the packaging of products or services.

In relation to the insurance sector, the FSA is potentially concerned about rules concerning the customer's eligibility to claim or the insurer's withdrawal of cover in certain circumstances, as well as complex claims notification procedures which may deter claimants.

In terms of investments, the FSA states that it will be looking out for features such as the use of product names implying greater safety or return than possible and charges unrelated to the level of service provided, e.g., a passive collective investment scheme with a high annual charge.

---

[2] See Morrison & Foerster client alert: European Commission consultation on the review of MiFID (21 December 2010), http://www.mofo.com/files/Uploads/Images/101221-European-Commission-Consultation-on-the-Review-of-MiFID.pdf.

[3] See Policy Statement 10/6: Distribution of Retail Investments: Delivering the RDR – feedback to CP09/18 and final rules, http://www.fsa.gov.uk/pubs/policy/ps10-06.pdf.

[4] See Morrison & Foerster Structured Thoughts Volume 1 Issue 18, http://www.mofo.com/files/Uploads/Images/101217-Structured-Thoughts.pdf.

The FSA regards such indicators as warning signals that a product might be detrimental to consumers if the risks are not sufficiently managed by firms through product governance processes, but acknowledges that whether or not these constitute a cause for concern will have to be decided on a case-by-case basis.

For example, a complex product which is suitable for sophisticated investors could be detrimental if sold to less sophisticated investors. Therefore, the FSA requires that firms implement a distribution strategy for such products aimed at limiting the audience to suitable investors.

The New Regulatory Approach

The FSA intends that firms (especially the largest provider firms) will be subject to greater supervisory and enforcement focus on their product governance process, which will be assessed according to various criteria including: (i) whether the fair treatment of customers is built in to the firm's product development and distribution strategies; (ii) how it has defined its target market for a product and whether its governance process ensures the product is designed appropriately for the target market; (iii) whether its incentives and remuneration policies seek to avoid conflicts of interest and control risks of mis-selling and (iv) the extent to which risks are identified to the customer and the product is stress-tested to ensure fair results for customers. The FSA proposes to adapt the assessment methodology according to type and size of firm.

Where several providers are involved in providing a single financial product or solution (e.g., a self-invested personal pension (SIPP) in which the customer holds units in a CIS through a fund supermarket), the FSA believes that the firm at the top of the structure should take on a greater responsibility for the overall structure.

In relation to advised sales, the FSA proposes that the distributor or adviser should be responsible for assessing the suitability of the overall advice or recommendation for the particular customer, whilst providers should be responsible for designing products that work as expected and deliver "good outcomes" for consumers (although, unhelpfully, the Discussion Paper provides no guidance as to the basis on which to determine whether a particular outcome is good or otherwise).

More Prescriptive Product Governance Rules

The FSA proposes to introduce greater prescription in the product governance regime to focus on the fair treatment of customers and to improve its ability to punish firms for product governance failures. The FSA suggests that this may involve converting the current FSA Handbook guidance on "Responsibilities of Providers and Distributors for the Fair Treatment of Customers" (RPPD)[5] into rules and introducing high level rules requiring product providers to minimise inherent risks from the product and processes to ensure "fair consumer outcomes" from their product design and distribution strategies (again, no guidance in the Discussion Paper as to how to judge what is a "fair outcome." In addition, detailed requirements would apply and would address each stage of the product life cycle. Matters to be addressed would include risk mitigation, fair charging structures and rules aimed at venting mis-selling. In addition, the distribution of products would need to be monitored to ensure that products are reaching only their target market. The FSA would also require appropriate qualifications for staff who sign off on products.

[5] FSA Providers and Distributors Regulatory Guide Instrument 2007 (FSA 2007/41), http://fsahandbook.info/FSA/handbook/LI/2007/2007_41.pdf.

Additional Product Intervention Options

In addition to more prescriptive rules based on the existing regulatory framework, the FSA also envisages the need for it to apply one or more additional intervention options if it considers a product to be potentially detrimental to consumers. It acknowledges that many of these intervention options are extremely radical and lists the possible options, starting with the most radical, as follows:

- pre-approving products (or, as an alternative, requiring pre-notification of products);
- banning products;
- banning or mandating certain product features;
- applying more proactive price interventions (including looking at the relevant charging structure, comparisons of pricing with other appropriate products, whether the overall charge is so high that it undermines the possibility of achieving a reasonable return and (in the most extreme cases) capping the overall level of charges);
- increasing prudential requirements on smaller providers, including requiring firms to hold additional capital to meet any claims arising from "undesirable" products – larger firms will generally already be subject to capital requirements;
- providing consumer and industry warnings, including publishing of a list of products considered generally unsuitable for the mainstream, retail market;
- mandating risk or "health" warnings;
- preventing non-advised sales and limiting sales according to client category (e.g., prohibiting non-advised sales for certain complex products)[6]; and
- adding new competence requirements for advisers, including more specialist professional qualifications for advisers of certain non-mainstream products.

The FSA acknowledges that an overly intrusive approach to product intervention would have the effect of stifling innovation in the market and reducing consumer choice and that further analysis and debate is required before deciding which of these options should become part of its regulatory toolkit. Indeed, many of these intervention options are currently not within the FSA's powers and would require additional legislation.

Quite apart from not stifling consumer choice, a much more practical issue for the FSA is that it would not have the resources to consider each product individually. A regime of pre-approving (or even being pre-notified of) products generally is therefore likely to be unworkable. Having said that, the FSA believes that there may be a case for pre-approving *specific* products where it finds recurring problems with a product type. In addition, with any concept of pre-approval it is concerned there may be moral hazard issues in a regulator signing off on a product (and thereby implicitly assigning a "quality kitemark" to that product).

With regard to the power to ban products, the FSA envisages this would be used relatively rarely. It may, however, be more inclined to ban certain features of products it believes have a high risk of causing detriment. The latter option could still have a similar effect to a ban in practice, given how difficult it is to strip out a feature from a product and still retain an economically viable product.

---

[6] This strikes similar chords to the current "execution only" exception to the appropriateness test for non-complex products under the MiFID, which is currently under review by the EU Commission. No doubt the point will be made to the FSA, as to the EU Commission, that the more advice (or, as the case may be, assessment of appropriateness) required, the higher the cost of the product, at least some of which will be passed on to consumers).

The FSA expects to be more proactive in intervening on pricing, and while admitting that price capping of products is extremely difficult, the FSA still envisages the process could be used on an interim basis in extreme circumstances.

It is envisaged that, in practice, the most commonly used options are likely to be prevention of non-advised sales of some products and imposition of additional competence requirements for advisers.

Next Steps

Responses to the Discussion Paper may be submitted by 21 April 2011. The FSA states that it will use the responses to inform the papers which it intends to publish in the first half of 2011 on its expected approach to the transfer of its consumer protection function to the FCA.

Meanwhile, the FSA's 2011 Retail Conduct Risk Outlook published on 28 February 2011 provides some indication of the products/features which are most likely to be in the FSA's cross-hairs in the coming year, based on the FSA's perception of consumer detriment caused by them. Certain of these products/features were already highlighted in its 2010 Financial Risk Outlook, such as unfair terms in mortgage contracts, structured investments and deposits and payment protection insurance. Further down its list of priorities are those products and features which have not yet caused widespread customer detriment, but about which it has concerns, such as discretionary portfolio management, with profit funds, unregulated collective investment schemes, exchange-traded funds and self-invested personal pensions.

Contacts

Peter J. Green
+44 20 7920 4013
pgreen@mofo.com

Helen Kim
+44 20 7920 4147
hkim@mofo.com

Jeremy C. Jennings-Mares
+44 20 7920 4072
jjenningsmares@mofo.com

About Morrison & Foerster