# Product intervention – what should the future hold?

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The Herbert Smith financial services team recently hosted a roundtable discussion with high profile members of the financial services industry and a key policymaker at the FSA, to discuss product intervention and what shape the future landscape should take. This paper explores some of the key matters and issues debated. It will be of interest to anyone involved in the design, distribution and/or monitoring of financial products. It considers:

- How outcomes for product regulation should be defined
- What firms’ obligations should be and how they can be made clear
- What balance should be struck between regulating specific product features and/or regulating the governance and design process
- What case-by-case intervention should look like and when the powers should be exercised
- What the interaction with European requirements and the role of the European Supervisory Authorities should be
- What firms should be doing now

### Key issues

- A new appetite for product intervention will be at the core of the FCA
- Converting existing guidance into rules may make obligations clearer, but may also enable supervisory and enforcement action to be taken easier
- Firms should take steps now, including reviewing and ensuring robust policies and processes are in place to identify target markets and to support design of products appropriate to those markets
- Regulatory scrutiny and challenge of product design will increase before a product is brought to market
- Breaches of product intervention rules may render agreements unenforceable, which is likely to cause legal certainty issues
- FSA/FCA must strike a difficult balance between product provider and distributor responsibility, and firm and consumer responsibility
- Firms will be expected to create and distribute products that offer reasonable value for money, which is likely to involve the regulator assessing commercial judgements
- Defining undesirable products/features with sufficient precision, and clarifying the criteria around interventions, is of utmost importance
- Policy makers need to give further thought to compatibility with European legislation

### Timeline

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
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<tbody>
<tr>
<td>2012</td>
<td>27 June: House of Lords Committee stage of Financial Services Bill</td>
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<td></td>
<td>By end of year: Financial Services Bill to receive Royal Assent (secondary legislation to be enacted thereafter)</td>
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<td>Late 2012/early 2013: FSA product intervention CP</td>
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<td>2013</td>
<td>March: Full implementation of new regulatory structure</td>
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<td>2014 onwards</td>
<td>End 2014/early 2015: MiFID II and MiFIR expected to be implemented/become directly applicable</td>
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### A new approach?

**Product intervention “... is fundamental to shaping the regulatory philosophy of the new organisation” Adair Turner**

As proposals for reforms to the regulatory architecture have unfolded over the last two years, it has become clear that a new appetite for product intervention will be at the core of the FCA.

The Financial Services Bill, from conception, has contained a broad express power for the FCA to make product intervention rules. The trigger for intervention is when it appears necessary or expedient to the FCA for the purpose of advancing the consumer protection or the competition operational objectives (or the integrity objective if ordered by the Treasury). The intention is that this will enable the regulator to intervene, for example, to ban products or impose restrictions on features of products, quickly, when it considers that a product or product feature is likely to result in significant consumer detriment. As the Bill has passed through the legislative passage, the substance of this provision has remained unamended.

The FSA’s approach has traditionally focused on making rules and supervising at the point-of-sale (financial promotions, product disclosures, selling practices etc). The focus will now be on intervening earlier in the value chain, putting into the spotlight the obligations of product providers, in the design, development and distribution of products (see diagram 1). This is likely to increase regulatory scrutiny and challenge of products before they are brought to market. Early product intervention is a step change in the approach to supervision and signals a shift towards greater regulatory intervention and an even more intrusive approach. It is one of the more hotly debated aspects of the new regulatory regime. It is however only one cog in the consumer protection machinery, as other related workstreams, driven at both national and European level, are underway (see diagram 2 and Annex A).
Are the new powers necessary?

At times, it has been overlooked that the new power in the Bill is not a power to intervene - it is a power to make rules. The FSA of course already has the power to make product intervention rules. It already has the power to make both formal and informal product interventions, for example by issuing formal guidance, Dear CEO letters and taking supervisory and enforcement action etc. Moreover, pursuant to s.45 FSMA (the FSA’s own initiative variation of permission (OiVOP) power) the regulator can already intervene, for example, to impose requirements on products, mandate minimum standards/features, restrict sales to certain classes of consumers, potentially block a product launch or stop an existing product from volume sales. Indeed as diagram 3 illustrates, the FSA has already been busy intervening.

This begs the question as to whether it is necessary to introduce the relevant provisions into the Bill, and whether regulatory concerns could have been better dealt with by:

- Greater enforcement of existing regulatory requirements: suitability obligations, disclosure requirements, systems and controls in relation to product design, distribution and monitoring.
- Increased communication between the FCA and firms (which corresponds to the Treasury Select Committee’s recommendation that greater communication between the regulator and firms should reduce the need for product intervention).
- Allowing natural market forces to operate: new market entrants and product innovation could potentially eliminate problems.

Diagram 1

Key

- Increased focus
- Increased focus as a result of other work-streams
- Traditional focus

Interventions
The fact that the FCA is being granted a specific rule making power may however be seen as a positive development: these rules will be of general application across categories of products and firms, rather than being targeted at individual firms, helping to ensure a level playing field.

Regardless, introduction of the provisions has provided some political capital and served to draw attention to the new regulatory approach.

**How should the outcomes for product regulation be defined?**

To decide how the outcomes for product regulation should be defined requires first considering what the FCA is seeking to achieve. Another way of looking at this is to consider “what success would look like” in terms of product regulation.

In short, preventing problems of mass detriment (such as the issues relating to PPI) arising in the future appears to be the desired outcome.

Of course, we already have the TCF Outcomes, certain of which, taken together, may effectively already meet this outcome. In particular:

- **Outcome 2**: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.

- **Outcome 5**: Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.

Some of the FSA guidance to date appears to give us a route map to achieving these TCF outcomes. In particular, the four steps in relation to product design in the Structured Products guidance of March 2012 which can be summarised as follows:

- Identify the target audience and design a product that meets their needs
- Test the product to make sure it does what it says on the tin
- Have a robust approval process in place before products go on sale
- Monitor who is buying and how it is performing
Arguably, the outcomes should differ for different types of consumers – there is after all a specific acknowledgement of this distinction in the consumer protection objective in the Financial Services Bill – but, as crafted, TCF outcomes 2 and 5 seem sufficiently broad to allow for the different needs of different consumers to be addressed.

The question really is therefore whether the FCA needs to go any further than the existing TCF outcomes, at least in terms of defining outcomes.

What should firms’ obligations be?

As mentioned above, the regulatory focus is expected to shift towards the obligations of product providers in the design and distribution of products as well as distributors in monitoring sales and performance. The FSA has set out its expectations in DP11/1 and FS11/3 – see Annex B for a summary. Further, diagram 1 identifies some hot spots in the product life cycle which will give rise to regulatory expectation and scrutiny. Many of these obligations are already embedded in the Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD) guidance (which, broadly, focuses on governance/ responsibilities) and so will already be familiar to firms.

Diagram 3

Examples of product intervention action already taken

- Competition Commission prohibition on: selling PPI at the point of sale until after seven days after the sale, and sale of single-premium PPI policies (came into effect on 6 April 2012)
- FSA Dear CEO letter asking firms to stop selling single premium PPI with unsecured loans by 29 May 2009
- Following FSA report stating that most sale and rent back transactions were unaffordable or unsuitable, SRB firms stopped taking on new business/cancelled their permissions
- FSA finalised guidance warning that TLPs are unsuitable for mass retail market
- FSA consultation on ban of all marketing / selling of TLPs to “vast majority” of retail clients (later this year)
- CPP Group Plc suspended listing of shares with immediate effect and stopped selling identity protection products, following discussions with the FSA

Offering value for money

"It is possible to envisage the role of the regulator in imposing limits on price or excessive charges to remedy competition problems"

FSA FS11/3

An important shift in dynamic is that firms will be expected to create and distribute products that offer reasonable value for money rather than being driven by business models.

In policing this requirement, the regulator will be prepared to make judgements on product pricing decisions and the value that products offer. This may well result in the regulator becoming embroiled in questions which are essentially commercial judgements, and second guessing whether or not a product offers good value for customers. Assessing what is good value will be fraught with difficulties: what is good value for one person, may not be for another; how will the regulator determine when a product ceases to offer value? How deeply the FSA/FCA is prepared (and indeed equipped) to delve into such matters is a cause for concern for the industry. The FSA has indicated that, had it had the new powers at the relevant time, it could have introduced temporary rules to apply a cap on remuneration on sales of single premium PPI, set at a maximum profit at a level equivalent to other insurance products. However, it is
easy to make such statements with the benefit of hindsight. It will be more difficult for it to make real-time judgements.

It is important to note that there are already various requirements relating to consumer costs (although not value) scattered through the Handbook (eg, in relation to mortgage arrears, although rules on excessive charges for a wider range of investments have been mooted). Further, the FSA has already taken some steps towards making judgements in this area. In February 2011 the FSA fined a firm £840,000 for (amongst other things) applying unfair charges in that they did not accurately reflect the cost of administering mortgage accounts in arrears. In its thematic work on pensions switching, the FSA took a close look at product costs in determining whether pensions transfers were suitable.

Traditionally, the FSA has not been a price regulator, in the way that utilities regulators are. Nor is it intended that the FCA will be an economic regulator in the sense of prescribing returns for financial products or services. However, statements in the paper outlining the FCA’s approach to regulation, confirm that a change is on the horizon: “The FCA will, however, be interested in prices because prices and margins can be key indicators of whether a market is competitive. Where its powers allow, the FCA will take into consideration more positively the cost of products or services in making judgements about whether consumers are being fairly treated”. The FCA’s objective to promote effective competition may also fuel the FCA’s willingness to look at profitability and price, as being possible indicators of weaknesses in competition. However, as little has been said to date about how the FCA will fulfil its competition mandate, it remains to be seen how the competition objective will play out in this space.

A key question is whether the regulator is best placed to make these judgements. On one view, price decisions should be left to the market and be determined by competition. It will be critical for the FCA to have relevant expertise in order to intervene appropriately. The FSA says it has already recruited staff with product design expertise, but it will also need specialist expertise to enable it to make judgements on pricing/value. It will also need a joined up approach with competition regulators to ensure consistency of approach, and a solid understanding of how the markets operate across the diverse sectors.

A comparison with competition law processes

While no direct parallel can be drawn with the framework in which the competition authorities and other sectoral regulators make price interventions, reference to that framework may be instructive. For example, the Competition Commission’s statutory threshold for intervention in a market investigation is whether there are features of the market that could have an adverse effect on competition. In contrast, when making production intervention rules, the FCA will only need to consider whether it is necessary or expedient in advancing its objectives – a significantly lower threshold than that to which the Competition Commission, for example, is subject. Further, the FCA need not actually prove a breach of any rule when making firm-specific interventions in exercising its QIOP power.

When the Commission or a sectoral regulator assess matters such a profitability and price regulation they generally do so on the basis of established cost methodologies, economic models, etc. In short, there is a degree of predictability as to the framework to be applied. In contrast, it is currently unclear what framework, economic models and process (if any) the FCA will apply in making price determinations and/or interventions. Specification will be crucial in informing the current debate and guiding firms in meeting expectations. Clarity will also be required on the criteria to be applied when the FCA proposes to move along the spectrum from softer interventions to more extreme price interventions, and whether the regulator is still committed to market failure analysis.

Interventions by the Competition Commission (and in most cases by sectoral regulators) are ultimately subject to challenge in the specialist Competition Appeals Tribunal. Product intervention decisions of the FCA can also be contested, although the circumstances in which challenges can be mounted, will be limited. The Bill limits the course of action available to the Upper Tribunal in the event it chooses not to uphold the FCA/PRA’s decision and will not permit it to substitute its decision for that of the regulator, except in relation to disciplinary matters and those involving third party rights. Instead, the Tribunal must remit the matter back to the regulator with such directions, eg, on issues of fact or law. This means that where the FCA seeks to make product interventions in relation to a particular firm, there will be limited grounds of challenge, unless, for example, the FCA has fundamentally misunderstood a product. Where firms wish to challenge product intervention rules, judicial review will be the only means of challenge. This in itself will be a limited remedy, given the FCA’s sweeping discretion.

A difficult balancing act

Product providers v. distributors

The issue of where the balance between product provider and distributor responsibility should lie is complex. Should it ultimately be for the distributor to determine whether a product is suitable for a client? Is it right that a product provider should be held responsible where a product is “unsuitably” distributed?

Carving up responsibilities is understandably problematic, particularly where distributors play a role in determining product design and terms, and the line between product creator and dispenser is blurred. The commercial dynamics are such that it may be difficult for providers to exercise control over their distributors. The RPPD offers some guidance in this situation. However, undoubtedly, further clarity is required. For example, what are the obligations on providers where products not designed for the target market are marketed and/or sold outside of the target market? To what extent must providers engage with distributors to ensure distribution strategies do not extend beyond the intended market (particular in sectors where a multitude of distribution platforms are used)?

Similar questions are also currently being grappled with in the context of the Retail Distribution Review (RDR), where requirements have been placed on product providers which
assume a relationship with the end client, in circumstances where providers, for example fund managers, are increasingly distanced from the end-investor.

**Firms v. consumers**

“You have to assume you don’t have rational consumers. Faced with complex decisions or too much information, they default ... they hide behind credit ratings agencies or behind the promises that are given to them by the salesperson.”

_Martin Wheatley_

The question of the extent to which the regulator should intervene in the design and sale of products is inextricably linked with the issue of consumer responsibility. Intervention is arguably at odds with the notion that consumers should take responsibility for their investment decisions. The difficulty is determining where the balance between the two lies. Pertinent questions that deserve more debate include: whether more of the onus should be on the consumer to understand the product information and ensure the product meets their needs. Whether more work should be done to encourage and/or assist consumers to take responsibility. Whether the new approach goes too far in absolving consumers from responsibility. Whether firms should be able to rely on the fact that the customer has confirmed they have read the product information and understood the product and its implications.

The FSA believes that there are limits to the responsibility consumers can be expected to bear. The view of the FCA's future Chief Executive that investors cannot be counted on to make rational choices and that regulators need to “step into their footprints” is perhaps cause for concern. However, such view has been mitigated to some extent with statements made elsewhere that it is “imperative” that investors are not completely absolved of the responsibility for their decisions.

It remains to be seen where the balance between firm and consumer responsibility sits. The FSA has attempted to elicit agreement on the appropriateness of the current balance, however predictably, a lack of consensus meant that this was not possible. Nevertheless, going forward, this should not dissuade the FCA from seeking to articulate, in practical terms, what responsibilities consumers and firms are, or are not, expected to shoulder.

**How can the obligations be made clear?**

“It remains to be seen whether transplanting what is currently guidance into rules will make obligations clearer, or whether it will simply enable the FSA to point to breaches and take supervisory and enforcement action easier.”

The FSA plans to produce a single set of rules and guidance on product governance. Indeed, drawing together currently dispersed material may be helpful for firms. The FSA also intends to convert some of the TCF material, including the RPPD into rules, although it is unclear what will become rules, and what will remain as guidance. It is hoped the FSA's forthcoming consultation paper (expected in late 2012/early 2013) will provide some clarity.

It remains to be seen whether transplanting what is currently guidance into rules will make obligations clearer, or whether it will simply enable the FSA to point to breaches and make supervisory and enforcement action easier.

On the one hand, more rules may be welcome, as it would provide an opportunity to make expectations clearer — provided that the rules are not drafted at a high-level of generality, but are still flexible enough to take into account different industry sectors. On the other hand, making more guidance may be preferable as it would be more flexible, albeit potentially at the sacrifice of clarity. It may be that the industry should seize the momentum the debate is generating to drive forward and develop a code of practice. The FSA accepts there could be some merit in this, as it would be more flexible and quicker to update than regulation.
What balance should be struck between regulating specific product features and/or regulating the governance and design process?

Some of what has been said about product intervention to date – including the comment in FS11/3 that the FSA has “no desire to dictate product structures to the market” – could lead to the conclusion that the FCA’s focus will be on firm’s governance processes – and so, if a firm has an appropriate and effective governance structure around the lifecycle of a product, that will suffice. This would appear to be consistent with the messages from the FSA that the RPPD will be turned into rules. It is also consistent with the work the FSA has been doing to date which has focused on undertaking assessments of product governance processes in firms.  

However, it is clear that the FSA/FCA will also be looking at specific products – we have a number of examples already (also see diagram 3):

- The most recent being the Traded Life Policy Investments (TPLIs) guidance of April 2012. In it, there is a strong recommendation from the FSA that TPLIs should not reach the vast majority of retail clients. Firms can still recommend TPLIs – but will need to be able to provide “detailed and robust justification for [their] reasoning”. This is an interim measure pending a consultation on a ban of all marketing of TPLIs to the vast majority of retail clients.

- In March this year, the FSA published guidance in relation to structured products. Despite being badged as relating to structured products, it is different in nature to the TPLIs guidance and focuses more governance than specific product issues – many of which will be relevant to other products as well.

- The draft PPI guidance of November 2011 was different again, setting out a range of risks, some of which relate to the governance process, other more to product features.

So, so far at least, it appears that the FCA will look at both governance processes and at specific products. This is not surprising as one flows from the other – the TPLIs guidance for example arises from work done by FSA which found “significant problems” in the way in which many TPLIs are designed, marketed and sold to UK retail clients.

What should intervention look like?

The FSA has identified eight types of intervention and intends to make use of the full range of tools, as appropriate. Diagram 1 illustrates what interventions may be deployed at each stage of the product cycle.

One key question is whether the costs of intervention will be disproportionate to what the FCA realistically can achieve – the FSA accepts it cannot create a zero failure regime. There will be a number of trade-offs for the regulator to balance and diagram 4 illustrates some of the factors it will have to weigh up when considering interventions. It is vital that it gets it right. The regulator will also need to provide clear and robust reasoning as to how it arrives at its decisions, otherwise it may face challenges later on.

Diagram 4

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<thead>
<tr>
<th>Consumer protection</th>
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<tr>
<td>Industry/consumer costs</td>
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<tr>
<td>Innovation</td>
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<tr>
<td>Choice</td>
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<tr>
<td>Competition</td>
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The tool kit

Bans on products, mandating and/or banning product features

This blanket form of intervention will be an extreme tool. It is of some comfort that the FSA believes it will be used relatively rarely. In considering its use, it will be critical for the regulator to be mindful of the fact that consumers are not a homogenous group. Where there are varied levels of consumer sophistication, blanket action may be imprudent. Such action could result in claims against firms in relation to products which have similar characteristics to the banned product, but which were not missold and were suitable.

Defining with sufficient precision which products or features will be targeted will be of utmost importance, in particular where products are packaged or embedded in other products, and to avoid the temptation for regulatory arbitrage. For example, if a banned product is embedded in a UCIS fund, what will the effect of the ban be? Will the UCIS be banned entirely? Or would the fund be prohibited in investing in the particular product?

Price interventions

Another dramatic form of intervention, this tool may involve:

- requiring firms to:
  
  - design products with appropriate charging structures;
  
  - benchmark advice at the point-of-sale, against a low-charged substitutable product; and
  
  - consider the appropriate overall charges for products, and

- imposing price caps.

Some of the same issues as above apply.

Pre-approval of products

The new approach is not intended to constitute any form of widespread pre-approval of products, which has been ruled out, for now at least. Pre-vetting may however ultimately form part of the regulatory machine should the Treasury Select Committee’s recommendation, that the FCA conduct a review of the merits and costs of a pre-approval scheme for simple financial products, be taken forward. Further, the FSA has not ruled it out respect of some products (although it is unclear which) in future. Regardless of whether such a system is implemented, there remains some risk that consumers may interpret the fact that the regulator does not intervene as a form of tacit approval or endorsement of those products. This risk will become more prevalent should the use of the product intervention power become widespread. This is a moral hazard that the FCA will need to manage generally in relation to interventions, on an on-going basis through its communications.

Notwithstanding the absence of a pre-approval system, firms may increasingly turn to the regulator before a product is launched, to seek informal assurances. Where the FCA engages with firms in this way, it will need to find a way of establishing a level playing field in terms of transparency of information provided to other firms.

Pre-notification of products

For now, the FSA is not proposing to require this, however it has not been ruled out.

Increasing prudential requirements on providers

The FSA had envisaged that this might be an appropriate tool for use in connection with smaller niche providers in certain markets – clearly it would not necessarily always be appropriate for the FCA to be seeking to impose such requirements on PRA-regulated firms. Whilst not ruling the use of such tools out completely, the FSA accepts that careful consideration would be required before implementation, and that the potential impacts of any other proposed measures would need to be taken into account.

Prevention of non-advised sales/limiting product sales to certain types of consumer

A majority of respondents to DP11/1 opposed this option. However, the FSA stated in FS11/3 that its use could be appropriate for particularly vulnerable customers or in particular circumstances, where the benefits outweigh the costs. Further, in the draft statement of policy on the use of the temporary intervention rules, the FSA indicated that it could have imposed temporary rules to prevent SCARPs being sold without advice, perhaps with a requirement for additional scrutiny of investor’s attitude to risk. Some associated issues, including the mooting of the abolition of the execution only regime, were raised in the context of the MiFID review consultation, and have yet to be resolved.

Additional competence requirements for advisers

The FSA has confirmed that any competence standards developed would need to be consistent with the RDR approach. It proposes to consider qualifications for advice in respect of transactions that cannot be reversed (eg pension transfer specialists), as well as coverage and linkage around pensions and retirement planning later this year.

Consumer and industry warnings, and mandated risk warnings

The FSA proposes to retain these as options, to be used sparingly on the basis of supporting evidence – there is some risk of requirements being super-equivalent to EU measures. Consumer and industry warnings can provide alerts about types of products which might cause consumer detriment at a far earlier stage than the publication of enforcement notices against individual firms (issued on completion of an often very lengthy investigation).
Unenforceability of agreements – a step too far?

A key change going forward is that contraventions of product intervention rules may render agreements unenforceable, if the particular rules stipulate that such consequence should ensue. The draft statement of policy on the temporary intervention rules, clarifies that this consequence would only apply to post-rule sales, where a claim for redress would only require the consumer to show that the sale took place after the introduction of rules. Difficulties in terms of legal certainty are likely to arise in relation to products which are similar to those which have been declared unenforceable, particularly if the rules are drawn at a high level of generality. Certainty in relation to the back book is also a problem, as product intervention rules may spur claims/complaints from existing customers where new sales of the same product have been declared unenforceable. There is a real risk that, in particular given its ‘fair and reasonable’ jurisdiction, the FOS may assess such complaints taking into account the unenforceability of post-rule agreements.

Uncertainties are also likely to arise in relation to existing liabilities and responsibilities of firms within the distribution chain. This extends to the validity of agreements in the wholesale markets, given the broadening of the definition of “consumer” to include some wholesale consumers, such as investment banks.

It will be crucial for the FCA to exercise its powers sparingly, and once exercised, for the rules to be drafted with sufficient detail, specificity and clarity.

Temporary rules

Somewhat controversially, the draft legislation permits the FCA not to consult in the case of the imposition of temporary rules, which could last for up to 12 months, not merely in an emergency, but where the regulator merely considers this to be “expedient”. Removing the consultation requirement significantly dilutes the checks and balances on this power. Further, expenditure, arguably, is far too weak a test for such intervention and it is not sufficiently clear why, instead, the FCA should not be required to consult on the formalisation of a temporary ban within an appropriately short timeframe. Whilst the Bill requires a statement of policy to be issued, the draft statement recently published, fails to clarify when temporary rules, as opposed to permanent rules, will be imposed.

When should intervention powers be exercised?

“Intervention should be the last tool that we reach for, and only when others have failed”

Martin Wheatley

As noted above, the FCA will have a sweeping discretion to make product intervention rules. The only statutory restraints will be: whether it considers it necessary or expedient in advancing its objectives (which in practice is not likely to limit its use), the requirement to consult and to take into consideration the responses, and to conduct a cost benefit analysis. The Government has acknowledged that this is a “powerful” tool. However, it is of some comfort that it has stated that it expects that it will only be used where it is appropriate and proportionate and that the powers should be used sparingly.

It will be critical for the FCA to give very careful consideration to the merits in each case – not all sectors should be treated the same. It will also be vital for interventions to be exercised consistently within each sector. The FCA will need to provide clear and robust reasoning as to how to arrives at its decisions to intervene.

Much will depend in practice on how the circumstances for the exercise of this power (the products, the product features, and categories of consumers etc) are defined. It will be difficult to balance precision and certainty on the one hand, with the creation of an amorphous set of rules which are difficult to navigate and which may prompt more guidance seeking from supervisors.

The Treasury Select Committee recommended that firms should be given clear guidance on when the powers will be exercised. The draft statement of policy on temporary intervention rules sheds some light on when intervention rules may be exercised, eg, where products:

• are outside the target market or being inappropriately targeted;

• would be acceptable but for the inclusion or exclusion of particular features;

• involve a significant incentive for inappropriate or indiscriminate targeting of consumers;

• in markets where the competitive pressure alone will not address concerns about a product;

• are restricted in their range or access in ways designed to increase profitability by restricting consumer choice, reducing competition, or creating barriers to search, switching, or entry; and/or

• are considered inherently flawed.

Although the scenarios have been put forward with temporary intervention in mind, there is likely to be read across. Nonetheless, further clarity is greatly needed around the criteria that will be applied.

What should the interaction with European requirements and the role of the European Supervisory Authorities be?

As regulatory rules are increasingly made in Europe, within the UK the FCA will move to becoming – as Hector Sants put it – a “supervisory arm” of Europe in relation to conduct issues. But has the UK really given enough thought to compatibility with European legislation, and to the need for coordination and cooperation with the ESAs and other competent authorities, or are we enshrining potential problems for ourselves in the proposed legislation and policy approach? Click here for further discussion.
Checklist: what should firms be doing now?

Even though the new statutory power is not due to come into force until Spring 2013, the FSA is already adopting a supervision-led strategy and taking action. There are a number of protective steps that firms should be looking to take:

1. Review systems and controls, particularly in relation to products identified as current/emerging risks (see Annex B), focusing on, and evidencing:
   - Product governance
   - Product strategies
   - Distribution strategies
   - Incentives
   - Risk and stress testing
   - Price and value
   - Execution and review
   - Monitoring products post sale

2. Review and ensure robust policies and processes are in place to identify target markets and to support design of products appropriate to those markets

3. Review product features to assess whether FSA may consider them to be problematic

4. Review/stress test business models where potentially problematic products are produced and/or sold, to assess consequences should the FSA take action in relation to those products

5. Review distribution agreements/processes, to ensure assurances regarding distribution to the target market are sufficiently robust

6. Expect an increase in scrutiny and challenge before a product is brought to market, even if the product is “low-risk”

7. Factor in delays and increased production costs

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1. Section 137C Financial Services Bill as inserted by clause 22.
2. Treasury Select Committee Financial Conduct Authority report, paragraph 145.
5. Ibid.
6. Paragraphs 1.15 – 1.16.
8. Ibid.
10. FSA DP08/5 and FS09/2.
11. DP11/1 Chapter 4 contains some detail on what the FSA is looking for from firms in this regard
15. Treasury Select Committee Report, paragraph 166.
16. Section 137C(7)(a) FS Bill as inserted by clause 22.
17. Section 138N FS Bill as inserted by clause 22.
18. Treasury Select Committee Report, paragraph 145.
20. These products are identified in the FSA’s Retail Conduct Risk Outlook 2012, in addition to products discussed elsewhere in this paper ie, PPI, structured products and TPLIs.
21. In May, the Swiss FINRA fined Wells Fargo, Citigroup, Morgan Stanley and UBS US$9.1m for mis-selling ETFs to retail investors. FINRA found that the banks had failed to impose proper controls on their staff who sold leveraged ETFs. The banks will pay a combined US$7.3m in fines and US$1.8m in
### Some mis-selling predictions

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<tr>
<th>Product</th>
<th>Risks/issues as identified by FSA(^{10})</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bundled products</td>
<td>• Insurance products of limited use and poor value being bundled with other products</td>
</tr>
<tr>
<td></td>
<td>• Lack of price transparency</td>
</tr>
<tr>
<td></td>
<td>• Risk of increased switching costs</td>
</tr>
<tr>
<td>Exchange Traded Funds (ETFs) and other exchanged traded products</td>
<td>• Lack of consumer understanding</td>
</tr>
<tr>
<td></td>
<td>• High counterparty and collateral risks</td>
</tr>
<tr>
<td></td>
<td>• Potential conflicts of interest in how these products are structured</td>
</tr>
<tr>
<td></td>
<td>• ETFs are primarily supervised by overseas regulators and investor protections may differ from those in the UK</td>
</tr>
<tr>
<td></td>
<td>• Marketing and promotional material not adequately reflecting risks</td>
</tr>
<tr>
<td>Absolute Return Funds</td>
<td>• Lack of consumer understanding (e.g., believing there is an element of capital protection, or guarantee of a positive return)</td>
</tr>
<tr>
<td></td>
<td>• Unexpected financial loss if funds that fail to perform</td>
</tr>
<tr>
<td></td>
<td>• Complex strategies</td>
</tr>
<tr>
<td></td>
<td>• Lack of financial adviser understanding</td>
</tr>
<tr>
<td>Self-invested personal pensions (SiPPs)</td>
<td>• Problems with systems and controls: lack of robust procedures for carrying out important functions such as reconciliations of SiPP member bank accounts with the firm’s SiPP provider, annual valuation of members’ assets and retaining proof of title of clients’ investments</td>
</tr>
<tr>
<td></td>
<td>• Conflicts of interest where the SiPP operator administers and advises on SiPPs</td>
</tr>
<tr>
<td>With profits funds</td>
<td>• Ineffective governance, particularly in how independent challenge is provided by firms’ with-profits committees</td>
</tr>
<tr>
<td></td>
<td>• Significant weaknesses in the quality of consumer communications – lack of sufficiently comprehensive, timely and clear information</td>
</tr>
<tr>
<td></td>
<td>• Complexity, lack of transparency, inherent conflicts of interest</td>
</tr>
<tr>
<td>Mortgages</td>
<td>• Inclusion of “unfair terms” in contracts, in particular in relation to interest variation; immediate repayment and switching from interest only to repayment</td>
</tr>
<tr>
<td></td>
<td>• Innovation leading to complexity</td>
</tr>
</tbody>
</table>
Annex A
Chronology

<table>
<thead>
<tr>
<th>Date</th>
<th>Milestone</th>
<th>Overview</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>FSA work on Treating Customers Fairly</td>
<td>Work on expectations for product governance</td>
</tr>
<tr>
<td>December 2008</td>
<td>FSA DP08/5 on consumer responsibility</td>
<td>Intended to provoke debate and agree the appropriateness of the current balance of responsibilities between consumers and firms</td>
</tr>
<tr>
<td>September 2009</td>
<td>FSA FS09/2 on consumer responsibility</td>
<td>Reaffirmed FSA's current regulatory approach to balancing the responsibilities of consumers and firms</td>
</tr>
<tr>
<td>November 2010</td>
<td>Financial Services Consumer Panel – research into “safer” products</td>
<td>Explores whether “safer” products should be developed for retail, medium to long term savings and investments market</td>
</tr>
<tr>
<td>December 2010</td>
<td>HMT consultation on simple financial products</td>
<td>Proposed principles for a new category of simple products</td>
</tr>
<tr>
<td>1 January 2011</td>
<td>European Supervisory Authorities’ powers on intervention came into force</td>
<td>Powers to temporarily prohibit or restrict certain financial activities which threaten the orderly functioning and integrity of financial markets or the stability of the EU financial system</td>
</tr>
<tr>
<td>January 2011</td>
<td>FSA DP11/1 on product intervention</td>
<td>Proposed the FSA's more intrusive approach to product regulation</td>
</tr>
<tr>
<td>June 2011</td>
<td>FSA FS11/3 on product intervention</td>
<td>Confirmed the FSA’s new approach to product regulation and set out the new supervision strategy</td>
</tr>
<tr>
<td>June 2011</td>
<td>Publication of Financial Services Bill and White Paper</td>
<td>Set out new powers for FCA to make specific product intervention rules</td>
</tr>
<tr>
<td>October 2011</td>
<td>HMT feedback to consultation on simple financial products</td>
<td>A new steering group tasked with devising a suite of simple financial products was established. Group will report back to Mark Hoban by July 2012. Responses suggested that the group should initially focus on simple deposit savings and protection insurance products. Other areas likely to be considered include investment products</td>
</tr>
<tr>
<td>October 2011</td>
<td>MiFID review</td>
<td>Proposed powers for ESMA and national authorities to prohibit or restrict the marketing, distribution or sale of certain financial instruments or financial instruments with certain features; or a type of financial activity</td>
</tr>
<tr>
<td>1 May 2012</td>
<td>FCA draft statement of policy on exercise of temporary intervention rules</td>
<td>Sets out the FCA’s policy on the making of temporary intervention rules and gives examples of previous market issues where such rules may have been considered</td>
</tr>
</tbody>
</table>
Annex B
Expectations on firms

Product governance
- Board engagement
- Clearly allocated responsibilities
- Effective inclusion of CFs (eg compliance) in oversight
- TCF should be embedded in product design
- Substantive challenge by compliance

Product strategies
- Adequate challenge to product strategies
- Controls to ensure customer need is reflected in strategy and evidence that controls have led to improvements

Market targeting
- Policies to support design of products appropriate to target market
- Design process leading to appropriate matching to target market
- Plausible target market in terms of size and composition
- Consideration of what customer needs the product would not fulfil

Distribution strategies
- Controls that ensure distribution channels and strategy are compatible with needs of the target market
- Details of the target market, product features and risks must be accurately conveyed to distributors
- Interactions and communications with distributors should lead to fair customer outcomes
- Taking action to address mismatches between the actual distribution/sales and the intended

Incentives
- Compliance with Remuneration code on avoiding conflicts of interest remuneration policies

Risk and stress testing
- Evidence to show depth and breadth of risk assessment and stress testing
- Clear identification and management of consumer risks
- Robust stress and scenario testing to ensure the delivery of fair customer outcomes
- Evidence that any subsequent changes to product features mitigate risks

Price and value
- Products should offer reasonable value for money for customers
- Product design should be driven by features that benefit the customer and not by business models
- Product costs should be compatible with the objectives of the product
- Evidence that conflicts of interest have been avoided/managed effectively

Execution and review
- Regular reviews, good use of customer feedback, ongoing active management of the product
- No outstanding risks to customers resulting from flawed implementation;
- Appropriate mechanisms to ensure that lessons learned (eg, from complaints) are fed back into the product development process
- Evidence that post-sale analysis is used to make changes that have improved customer outcomes in existing or new products
- Appropriate action if the product is no longer behaving as expected
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