



## Product Intervention in the UK and the New FCA

### Background

As we have previously discussed,<sup>1</sup> the UK Financial Services Authority (the “FSA”) signalled a sea change in the way retail financial products will be regulated in the UK in its Discussion Paper<sup>2</sup> on product intervention published in January 2011 (the “Discussion Paper”). In the Discussion Paper, the FSA stated that its existing regulatory approach had not prevented a series of product failures leading to significant customer detriment. It therefore proposed a much more interventionist and intrusive approach to regulation in this area involving earlier regulatory intervention and subjecting firms to greater supervisory and enforcement focus. In its recent Feedback Statement<sup>3</sup> published in June 2011, the FSA provides a summary of the feedback from the 84 responses it received and its proposed next steps.

The FSA is in the process of being broken up and its functions will be transferred to new bodies. In the context of product regulation, most of the relevant functions of the FSA will be transferred to the new Financial Conduct Authority (the “FCA”), which will have responsibility for regulating how firms conduct their business, with the objectives of securing an appropriate degree of protection for consumers, promoting efficiency and choice in the financial services market and protecting and enhancing the integrity of the UK financial system. In June 2011, HM Treasury published a White Paper and accompanying draft Bill<sup>4</sup> setting out the proposed framework for the new regulatory regime. At around the same time, the FSA also published a discussion paper<sup>5</sup> setting out its proposals for the approach to regulation by the FCA and which therefore ties in with the more interventionist approach to product regulation referred to above.

### Key Themes of Feedback Statement

The FSA states in the Feedback Statement that consumer organisations were broadly supportive of its proposed new approach, in particular the increased focus on the early stages of product development and marketing. Industry reactions were, however, more diverse. Some of the responses queried the need for increased product intervention, believing that the focus should be at the point of sale and noting that the FSA has already made

<sup>1</sup> See client alert, FSA Product Intervention dated March 14, 2011 - <http://www.mofo.com/files/Uploads/Images/110314-FSA-Product-Intervention.pdf>.

<sup>2</sup> FSA discussion paper (DP11/1): Product Intervention (25 January 2011), [http://www.fsa.gov.uk/pubs/discussion/dp11\\_01.pdf](http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf) (comments deadline: 21 April 2011).

<sup>3</sup> [http://www.fsa.gov.uk/pubs/discussion/fs11\\_03.pdf](http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf).

<sup>4</sup> [http://www.hm-treasury.gov.uk/d/consult\\_financial\\_regulation\\_condoc.pdf](http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf).

<sup>5</sup> [http://www.fsa.gov.uk/pubs/events/fca\\_approach.pdf](http://www.fsa.gov.uk/pubs/events/fca_approach.pdf).

significant changes to the regulation of retail products in its Retail Distribution Review and Mortgage Market Review aimed at raising standards at the point of sale. Others, however, supported greater intervention.

The FSA makes it clear in the Feedback Statement that, although it agrees that the point of sale is a critical element of regulatory focus and determining where consumer detriment arises, it also believes that product design and decisions about how products will be developed and to whom they will be marketed play an important role in determining consumer outcomes. It states that the regulatory approach will be to look primarily at the product governance processes employed by firms, whether there is effective competition for the benefit of consumers and whether firms are exploiting consumer behaviour. The starting point in relation to product intervention will be not to dictate product structures to the market but to correct problems where competition and the previous regulatory approach have been ineffective in meeting customer needs.

Concerns were raised by respondents as to the interaction of the new approach with regulatory developments in the rest of the EU and the possibility that UK firms could be at a competitive disadvantage if the UK takes a more interventionist, product-based approach than other EU member states. The FSA states that in developing the approach to product intervention, account will be taken of developments at an EU level, particularly the EU Commission review of the Markets in Financial Instruments Directive (“MiFID”) and its proposals in relation to packaged retail investment products (“PRIPs”). It also states that it will seek to make changes to EU directives where necessary, in particular to reduce the risk of cross-border arbitrage and products originating outside the UK undermining the effectiveness of the new approach to product regulation. It indicates that it will seek to promote a more interventionist approach at the new European Supervisory Authorities.<sup>6</sup>

The FSA states that it believes the new supervisory focus on products should be supported by a single set of rules and guidance. In this context it envisages that some of the Responsibilities of Providers and Distributors for the Fair Treatment of Customers (“RPPD”)<sup>7</sup> guidance be converted into rules. Having a single source of materials available for firms is likely to be helpful and provide greater certainty for providers of financial services. It will not be clear until further details are published, however, exactly how this consolidation will be effected and whether the current principles-based approach in the existing rules and guidance will be maintained.

In relation to its analysis of previous market failures and the need for an approach based on the whole life cycle of a product, the FSA states that it is aware of the difficulties involved in achieving the right balance and accepts it will not always be possible to identify and correct problems before they arise. Where things do go wrong, it is stated that the FCA will be more active in seeking redress. In relation to the question of which products merit an earlier intervention, the FSA had highlighted certain features in the Discussion Paper that might be used as indicators of products for which such approach could be appropriate. These are set out again in annex 2 of the Feedback Statement and include complex products (including bundled products or those with opaque structures), where the product carries an inherent conflict of interest, those products with secondary charges or layers of charges and products where the consumer is attracted by a teaser rate and then tied in. Other criteria were suggested by respondents including where there is evidence of deliberate bad practice, markets where competition works ineffectively and having a greater focus on smaller firms that have fewer resources to deal with problems.

The FSA notes that respondents stressed the importance of reviewing each case on its own merits, that investments inevitably involve risk and that complexity may be necessary for a product to function as expected. Respondents also noted that cross-subsidies are not always inappropriate and do not invariably lead to detriment and that different customers have different needs. The FSA accepts that more work will need to be done by the FCA in calibrating a more risk-based approach, in particular the importance to be put on the scale of detriment and the number of consumers affected. The FSA also stresses in the Feedback Paper that the new approach

<sup>6</sup> The European Banking Authority (“EBA”), the European Securities and Markets Authority (“ESMA”) and the European Insurance and Occupational Pensions Authority (“EIOPA”).

<sup>7</sup> FSA, 2007/41, [http://fsahandbook.info/FSA/handbook/LI/2007/2007\\_41.pdf](http://fsahandbook.info/FSA/handbook/LI/2007/2007_41.pdf).

should be viewed as covering all aspects of product governance including the ongoing management of products (whether new or existing products) and not just product design.

The FSA stresses that it envisages product intervention as being primarily a supervision-led approach at this stage. It does not, however, intend this to replace supervision of other parts of the value chain such as point of sales standards where it believes more action is required. The FSA also states that assessment of firms' business models and strategies will continue to form an important part of the FCA's supervisory approach, which it believes is an important part of ensuring good outcomes for consumers.

### **Additional Product Intervention Options**

The Discussion Paper set out various additional interventions that the FSA envisaged could be considered depending on how far the interventionist approach is pursued. Although many respondents had concerns in relation to some of the proposed approaches, the FSA indicates in the Feedback Statement that the FCA should be prepared to consider deploying all or most of these in appropriate circumstances:

**Product preapproval or notification:** The Discussion Paper indicated preapproval could be required for a limited number of products. The Feedback Statement reports that around 80% of the respondents commenting on this proposal strongly resisted the concept of preapproval. The FSA states that whilst it continues to rule out general preapproval of products, it does not rule out the possibility that it might be used in the future for certain products or markets. The FSA also states that it does not at this time intend to introduce a pre-notification requirement but, again, does not rule this out in the future.

**Banning products or product features and setting minimum standards:** The FSA states that respondents were divided on the desirability of outright product bans, although consumer organisations were generally in favour. The FSA states that it continues to believe that banning products or mandating or banning product features and exclusions should be considered where products or product features have the potential to or are causing significant detriment. The FSA also notes that it is currently proposed that the FCA will be given the power to ban products and the EU Commission is also considering the issue of EU-wide product bans.

**Price intervention:** The FSA had suggested in the Discussion Paper the possibility of focussing on product pricing decisions by firms and the value for money that products offer. It is noted in the Feedback Statement that a number of respondents were in favour of a requirement that firms design products with appropriate charging structures. There was, however, generally disapproval in relation to the introduction of a requirement for firms to consider appropriate overall charges for their products, the introduction of a point of sale responsibility to benchmark advice against a low-charged substitutable product or the introduction of price-capping. The FSA indicates that consideration will continue to be given to introducing requirements for product charges and it considers that interventions over value for money can be useful in certain circumstances to minimise consumer detriment in markets where competition is imperfect.

**Increasing the prudential requirement on providers:** The Discussion Paper suggested that prudential requirements could be increased for firms designing products likely to lead to detriment to ensure that firms have sufficient capital to deal with complaints and redress. The FSA states that only a minority of those responding agreed with this idea with a number commenting that prudential tools can be blunt instruments when dealing with conduct regulation. The FSA states that it has some sympathy with such an argument and careful consideration should be given to any such proposal before implementation.

**Mandated risk warnings:** The FSA indicates that many respondents were positive about the idea of consumer and industry warnings about products where deemed to be appropriate. The FSA indicates that it continues to believe such warnings remain an option, although they should be used sparingly and their use should be supported by evidence.

Prevention of non-advised sales or limiting product sales to certain types of customer: The FSA notes in the Feedback Statement that most respondents were opposed to the prevention of non-advised sales or limiting sales to certain types of customer. The FSA believes, however, the option should still be available where the FCA identifies particularly vulnerable consumers or particular circumstances in which a prevention of non-advised sales is the most likely route to improving customer outcomes.

## Overall Approach of the FCA

When the FCA is established, its strategic objective will be to protect and enhance confidence in the UK financial system. The White Paper published in June 2011 outlines in more detail the regulatory approach to be taken by it. The FCA will have three operational objectives:

- Securing an appropriate degree of protection for consumers
- Promoting efficiency and choice in the market for financial services
- Protecting and enhancing the integrity of the UK financial systems

The FCA will also be required to discharge its functions in a way that promotes competition and to have regard for six regulatory principles including proportionality of burdens or restrictions related to benefits, the general principle that consumers should take responsibility for their decisions, and openness and disclosure of relevant information.

Under the draft bill contained in the White Paper, the FCA will have a wide power to make general rules prohibiting or restricting authorised persons from entering into agreements that might have the effect of exposing consumers to an economic interest in specified products. These powers are therefore likely to assist it in adopting a more interventionist approach to product regulation.

The FSA discussion paper relating to the approach to regulation of the FCA is consistent with the Discussion Paper and the Feedback Statement, stating the FCA will be ready to intervene and make full use of its powers to tackle potential and emerging risks to consumer protection and market integrity before they materialise to prevent large-scale detriment. It states that the FCA will intervene early in relation to products where the risks are likely to outweigh the benefits and will give consideration to factors such as the number of consumers and the amount of their potential loss. It also notes that the FCA will seek to base its regulatory interventions on a deeper understanding of underlying commercial and behavioural drivers and the causes of poor outcomes for consumers.

## Next Steps

The FSA indicates in the Feedback Statement that changes need to be made to the regulatory approach to consider the entire life cycle of a product including product governance and distribution standards. As indicated above, it intends that a single set of rules and guidance be published on product governance including turning some or all of the Treating Customers Fairly materials into rules. It also notes that it will continue to monitor the various EU proposals impacting on retail products and will seek changes to directives where necessary. The transfer of the FSA's relevant functions to the FCA will of course have an impact on the nature of financial regulation in the UK even though many of the relevant personnel will remain the same. As stated above, it seems that the FCA will have additional powers to intervene at an early stage, which therefore complements the proposed new interventionist approach. The FSA states that the timetable to be adopted for the introduction of new rules and additional interventions will reflect the outcome of the legislative process in both the UK and the EU.

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