

Structured Thoughts

News for the financial services community.



Structured Products Guidance from the FSA

We have previously discussed¹ the “sea change” in the way retail financial products will be regulated by the FSA (and, later on, by its successor, the Financial Conduct Authority) in the UK, as highlighted in the FSA’s Discussion Paper² published in January 2011 and the “next steps” proposed in its Feedback Statement³ published in June 2011. The FSA’s focus on greater intervention at an earlier stage of the structured product life-cycle is again in evidence in a recent guidance consultation published in November 2011 (the “Consultation”).⁴

The Consultation sets out the FSA’s proposed guidance to product providers on their internal systems and controls relating to the development, design, marketing and distribution of structured products. In particular, it focuses on ensuring that such systems are adequate, in the context of what it sees as the increasing popularity and complexity of structured products, to minimise the risk of poorly-designed products and mis-selling, or mis-buying,

¹ See client alert, FSA Product Intervention dated March 14, 2011, <http://www.mofo.com/files/Uploads/Images/110314-FSA-Product-Intervention.pdf>; and client alert, Product Intervention in the UK and the New FCA dated July 5, 2011, <http://www.mofo.com/files/Uploads/Images/110705-Product-Intervention-in-the-UK-and-the-New-FCA.pdf>.

² FSA discussion paper (DP11/1): Product Intervention (25 January 2011), http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf.

³ FSA feedback statement (FS11/3): Product Intervention (June 2011), http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf.

⁴ FSA Guidance Consultation: Retail Product Development and Governance – Structured Products Review (November 2011), http://www.fsa.gov.uk/pubs/guidance/gc11_27.pdf.

further down the production/distribution chain. The focus of the Consultation is on the ways in which structured investment products (both principal protected and non-principal protected) and structured deposits (together, “structured products”) are designed and marketed to meet the needs of target customers, as well as the post-sales responsibilities of firms (although the FSA states that its focus, in this particular case, is on product providers rather than distributors).

We have summarised below the FSA’s proposed guidance and “actions” to be taken by firms, divided into eight areas. We have also separately summarised its proposed guidance on the application of the Unfair Terms in Consumer Contracts Regulations 1999 (“UTCCR”) to structured products.

Product Approval Procedures

The FSA expects firms to have “*transparent and auditable*” product approval processes which provide for clear roles and responsibilities for the individuals involved in the approval processes, and the processes should “*embed the delivery of fair outcomes for customers.*” The FSA also expects firms to have strict criteria for when a “light touch” approval process may be used and when the full, robust approval process should be required. Firms are advised to put in place a review mechanism to prevent “product creep,” where small changes to a product are made gradually over time, each time under a “light touch” approval process, resulting in an aggregate substantial product change which has not been subjected to the full approval process. It also expects that the process will incorporate effective opportunities for scrutiny and challenge, and that the process itself will be reviewed regularly and updated as necessary.

Product Development

In the context of the product’s development, the FSA highlights the importance of identifying the relevant target market, particularly in relation to identifying customer needs and objectives and designing the product to cater for them. In this regard, consumer research should be specifically designed to help assess the risk profile of the target market, such as their willingness and ability to bear loss and their possible recourse to compensation, such as the Financial Services Compensation Scheme (the “FSCS”). It should also be designed to help assess the investment objectives of the target market, such as whether they are looking for capital growth or return, and their attitude towards risk measured against reward. The FSA considers that firms should analyse the financial knowledge and experience of the target market and their financial background such as tax status and closeness to retirement. For advised sales of structured products, this analysis will not detract from the investment adviser’s responsibility to firstly understand the risks of the product and secondly make a suitable recommendation to the client.

The FSA also considers that changes in financial markets may mean that once-suitable products may later cease to be suitable for their target market, and encourages firms to consider such changes not only in the context of designing new products, but also in the context of considering their post-sales responsibilities (see below) to existing product-holders.

Design and Development of Product Features

The FSA considers that firms should ensure that product features which are visible to consumers are likely to be understandable by them so that they can see where their return is designed to come from, can assess the likelihood of receiving it and, where applicable, can understand that they may receive no return at all, or may lose capital. The FSA states that the design process should take account of factors such as how the gross returns of the product are divided up between the different stakeholders and whether the division (including fees and charges) is “fair” from the consumer’s perspective, as well as possible recourse to the FSCS (or another EU guarantee scheme), the distribution channel (in particular whether advice will be provided) and the tax consequences of the product’s pay-off profile.

The FSA suggests that firms need to be particularly careful concerning the ability of consumers to understand these factors in the case of linked product offerings where the purchase of one product (typically a deposit) is dependent on another (typically a structured product). For structured investment products, the FSA believes that firms should undertake sufficient due diligence in relation to the counterparty (e.g., the securities issuer), such as examining credit default swap spreads and other market information, rather than simply relying on its external credit rating.

The FSA also wants the choice of underlying assets or indices for a product to be driven primarily by consumer needs and not, for example, to match against other assets or liabilities on the counterparty's balance sheet. As with the product approval process, the FSA expects product design frameworks to incorporate procedures for periodic challenge and updating.

The FSA also states that the terms of consumer contracts for structured products should be clear and fair, and accurately represent the features of the product as designed, and it sets out in Annex 2 of the Consultation its guidance in relation to contractual terms to be considered in the design process.

Stress-Testing and Modeling

The FSA recommends that firms should routinely stress-test products for a variety of conditions – both in a situation of a product performing within its design parameters and in a case of the failure of a design feature. It expects stress tests should be robust, including allowing for challenge procedures, transparent and should be built into the product approval process, although they need not always be used, for example in the repeated issuance of a previous product.

In Annex 1 to the Consultation the FSA sets out its guidance for firms in relation to the technical aspects of stress tests, stating that stress tests should be forward-looking as well as involve back-testing, and that simulations should be carried out from the investor's point of view to understand the expected profitability of the product, grading different potential outcomes in terms of probability. The FSA warns against focusing such simulations excessively on asset classes and indices that have generated high recent returns, and so are more marketable. Separately, the FSA sets out in Annex 1 its recommendations for a firm's collateral management processes for structured investment products, including as to the liquidity and asset concentration of collateral and the extent of collateral segregation.

Marketing – Distribution and Communications

Firms are expected by the FSA to take care in the use of non-advised sales of products containing complex features which are difficult to explain, and in deciding the needs of the end-customer, firms should consider the retail customer at the end of the supply chain rather than just the distributors.

However, firms are expected to carry out due diligence on distributors, both initially and on an ongoing basis, including ensuring that products are in fact being sold to their target market. They are also expected to act on their assessments of distributors, as necessary, which action could include amending the product literature for future distribution, providing further training for distributors or limiting distribution to specific channels.

Information to Distributors

The FSA expects distributors to be given sufficient information on the structure of a product, its implicit charges and the market conditions needed to generate a particular outcome so that they can:

- understand the details of the product and its target audience;
- compare the product with other available retail products;

- understand the risk and reward aspects of a product and the cost-benefit analysis of capital protection; and
- understand all the conditions in which the product will perform as expected.

The FSA strongly encourages the use of training for the purpose of informing distributors appropriately. Once the likely training needs of the distributors have been appropriately identified, the training should be targeted to allow them to perform their functions to the consumer as effectively as possible.

Information to Consumers

The FSA urges firms to take action to ensure that information supplied to consumers is clear and is provided before, during and after the point of sale. Firms are expected to assess the nature and complexity of a product and the financial capability of the target market, and tailor the information accordingly. The information should promote the product features in a fair and balanced way, including giving a balanced view of the prospects of receiving maximum returns if returns are being promoted. The possibilities of less than maximum returns or no return at all must be clearly set out.

For structured deposits, the annual equivalent rate should be clearly set out, no less prominently than the minimum and maximum returns of the product.

Post-Sales Responsibilities

One of the stated aims of the FSA is to facilitate the ability of consumers to “*change product, switch provider, submit a claim or make a complaint*” after a sale has completed. Firms are expected to periodically review their products in order to ensure that they still meet the needs of the target audience, and ascertain whether they are on course for the performance originally expected. They are also expected to be able to communicate clearly the basis upon which such assessments are made.

Firms are also urged to develop a strategy to be followed to contact consumers if the performance of a product begins to deviate substantially from what consumers had been led to expect. The FSA also emphasises the importance of firms’ responsibility to treat consumers fairly throughout the life of a product and provide for easy methods of early redemption. They are also expected to provide support and assistance to consumers and distributors throughout the life of the product, and where such tasks are outsourced to third parties, they need to perform adequate due diligence on those parties and keep their performance under review.

Contractual Terms and the Application of UTCCR

In its review, the FSA also identified a number of structured product terms that could potentially breach UTCCR. These regulations protect consumers from terms that are considered “unfair,” by making them unenforceable against the consumer. The FSA, as a “qualifying body” under the UTCCR, is able to challenge these terms under the scope of the regulations.

The FSA focused its review on identifying those terms, which were not in good faith and caused significant imbalance in the respective positions of the parties⁵ or were not written in plain and intelligible language.⁶

The review focused on three types of terms used by firms in their structured products.

⁵ Contrary to Regulation 5 of the UTCCR.

⁶ Contrary to Regulation 7 of the UTCCR.

Exit Terms

These are terms which either:

- require a consumer to pay a fee to exit the contract early; or
- provide that, on exit by a consumer, the firm would sell the underlying securities in the structured product and refund the proceeds of the consumer's investments.

While the FSA appreciates that fluctuations in the market can make it difficult for firms to specify the exact charges applicable, it has suggested that the firm should at least inform the consumer clearly of the methods for calculating the charges, relating to each different exit circumstance. Additionally these terms should be made easy to locate in the contract, preferably contained in one clear, defined section.

Termination Terms

The FSA reminded firms of the need for the exercise of any termination right by the firm to be a proportionate response, in view of the materiality of the consumer's breach.

Variation Terms

The FSA referred firms to its Statement of Good Practice, in relation to the drafting of variation terms.⁷ It drew particular attention to the importance of specifying in the contract a valid reason for any variation of the contract, and reminded firms that in order to comply with UTCCR, firms may have to go further still, including possibly providing notice to consumers that a change has been, or will be, made.

Brochures Accompanying Terms and Conditions

The FSA was additionally concerned about the use of brochures to accompany the terms and conditions of structured products, in particular the growing trend of referencing these brochures in the terms and conditions to point out more detailed information about the product. The FSA has raised two issues about the use of these brochures, citing that any reference or link to the brochure must be clear and easily accessible, as well as warning that this use of the brochures may render all or part of the information contained in them assessable for fairness under UTCCR.

Next Steps

The consultation period ends on 11 January 2012 and the FSA has invited feedback on its proposed guidance for each of the eight areas listed above. In the meantime, the FSA encourages firms to consider the guidance in the Consultation and to compare their own governance procedures against such guidance.

⁷ FSA Statement of Good Practice: Fairness of terms in consumer contracts, May 2005, http://www.fsa.gov.uk/pubs/other/good_practice.pdf.

For questions, please contact:

Nimesh Christie, nchristie@mofo.com, +44 20 7920 4175

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

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

Morrison & Foerster named **Structured Products Firm of the Year, Americas, 2011** by *Structured Products* magazine.

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