

Structured Thoughts

News for the financial services community.



Final Structured Products Guidance from the FSA

In an earlier issue of *Structured Thoughts*,¹ we highlighted the guidance consultation of the UK's Financial Services Authority in relation to structured products. The consultation period ended on 11 January 2012, and the FSA has recently published its finalized guidance ("Guidance"),² as well as a separate summary³ of the feedback it received during the consultation period.

In short, the FSA has made no amendments to the proposed guidance on which it consulted, other than to add a clarification, in the context of simulations carried out to understand the expected performance of a product.

However, the FSA has separately provided some responses to the comments received on the consultation.

Provider/Distributor Differentiation

It was noted by some respondents that there should be an acknowledgment of the limits to product provider responsibilities toward end customers, particularly in circumstances which investment advice is provided by

¹ See *Structured Thoughts*, Volume 2, Issue 15, <http://www.mofo.com/files/Uploads/Images/111205-Structured-Thoughts.pdf>.

² Retail Product Development and Governance – Structured Product Review, March 2012, <http://www.fsa.gov.uk/static/pubs/guidance/fg12-09.pdf>.

³ <http://www.fsa.gov.uk/static/pubs/guidance/fg12-09feedback.pdf>.

another intermediary, such as a distributor. In answer, the FSA points respondents towards its previous guidance published in 2007, *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers* (“RPPD”).⁴ In particular, it refers to sections 1.15 and 1.16 of that guidance in which it acknowledges the variety of different functions and roles that different firms may take in relation to the life-cycle of the product, whether a particular role or function is fulfilled by a firm labeled as a “provider” or as a “distributor.”

In particular, it acknowledges that where a provider creates a product or service to meet criteria or designs which were specified by a distributor, then many of the responsibilities set out in the RPPD should fall to the commissioning distributor, as the “retail manufacturer” of the product, rather than the “pure manufacturer” of such product.

Level Playing Field

Some respondents were concerned that UK firms would be placed at a competitive disadvantage to those based outside the UK, in having to comply with this guidance of the FSA, and made the comment that structured product regimes should be made consistent across the EEA. They also urged the FSA to not effect measures now which might be later superseded by European initiatives.

The FSA responded firstly that it was aware of these concerns and intended to take them into account in developing its approach to product intervention. In addition, the FSA restated its intention to use its involvement in EU level projects to try to make any conforming changes to EU level legislation, and in trying to develop an appropriate product intervention approach at the level of the European Supervisory Authorities.

Scope

The FSA clarified that the application of the Guidance was not, as suggested by some respondents, intended to be limited to retail offerings in the sense in which that term is understood for offers of securities pursuant to the Prospectus Directive. Instead, “retail customer” was to be defined as it is in the FSA Handbook, “...an individual who is acting for purposes which are outside his trade, business or profession.”

It had also been suggested by some respondents that the Guidance should not extend to situations in which the firm was facing a client who was acting in the capacity of a discretionary asset manager—in other words where there was no on-sale of the product to retail customers. The FSA made clear in its response that the Guidance does apply generally whenever individual retail customers are exposed to risk from structured products.

Suitability and Post-Sales Responsibilities

Some respondents asked for clarification that the FSA had no intention of imposing “real time” suitability or appropriateness obligations on product providers, such as an obligation to continue monitoring the ongoing suitability of a product which had originally been assessed as suitable.

The FSA confirmed that the guidance was not intended to address point-of-sale suitability or appropriateness, nor to impose obligations on providers to ensure that a product remains generically suitable, post-sale, for the target investor.

Complexity and Risk

The FSA conceded the point, made by a number of respondents, that the complexity of a structured product does not necessarily bear any relationship to the riskiness of the product. The FSA confirmed that it does not equate complexity with riskiness, although it does consider that the more complex the structure and features of a product, the more difficult it is likely to be for a consumer to understand that product in a financial promotion.

⁴ http://media.fsahandbook.info/Handbook/RPPD_20070716.pdf and http://www.fsa.gov.uk/pubs/policy/ps07_11.pdf.

Forward-looking Modeling

Questions were asked by respondents as to the relative importance of forward-looking modeling compared to back-testing.

The FSA remains of the opinion that stress tests should be forward-looking, as well as back-testing, given the limited value of past performance. It acknowledges that firms cannot predict the future, but points to the fact that some firms already use forward-looking assessments to develop structured products. It reiterates that it expects the assumptions used for these purposes to be reasonable and based on publicly available data.

Selection of Distribution Channels

Some respondents had argued that a combination of analysis of a generic target market, together with a rigorous Know Your Distributor process provided a key element of investor protection, which should be reflected in the Guidance. However, the FSA responded that a rigorous Know Your Distributor process could not replace the process set out in paragraphs 10.4 to 10.9 of the Guidance—these involve carrying out due diligence on distributors and acting on the firm's assessment of its distributors, such as providing enhanced training for distributors, and where appropriate ceasing to use a particular distributor or limiting distribution to specific channels.

Information to Distributors

Various respondents stated their view that the information needed to be given to distributors should vary depending upon whether those distributors were authorised, independent or appointed representatives of a provider firm. However, the FSA does not agree with this view and regards its Guidance as relevant in respect to all distributors.

Next Steps

The FSA has stated that it is also consulting on new guidance, setting out its expectations about product development and how firms bring retail structured products to market, and it expects that this will involve turning some or all of the existing RPPD into rules. The FSA is still focused on identifying potential consumer detriment at an early stage, and, as we have previously outlined in earlier client alerts, it intends to achieve this by the dual approach of focusing on the early stages of the product life-cycle, and separately by adopting a much more interventionist approach to investment product regulation.

For questions, please contact:

Peter J. Green, pgreen@mofocom, 44 20 7920 4013

Jeremy C. Jennings-Mares, jjenningsmares@mofocom, 44 20 7920 4072

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology, and life science companies. We've been included on *The American Lawyer's* A-List for eight straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofocom. © 2012 Morrison & Foerster LLP. All rights reserved.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.