Product Intervention (DP 11/1)

A response paper by the Futures and Options Association

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1. Introduction

1.1 The FOA is the industry association for more than 160 firms and institutions which engage in derivatives business, particularly in relation to exchange-traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies, exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector.

1.2 The FOA's interest in responding to FSA's Discussion Paper "Product Intervention" ("DP") is:

(a) to reflect the interests of those of its members that are engaged in retail business;

(b) to urge the FSA not to extend product intervention into other service areas, as envisaged in para 1.15, and particularly not to wholesale business; and

(c) to emphasise the importance of striking an appropriate balance between fulfilling regulatory priorities and facilitating business and commercial needs in the provision of services and development of products.

1.3 The FOA will confine itself, therefore, to providing a high-level policy response to what is described in the Foreword as FSA's *"quite new and more intrusive approach"* to product regulation, including proposals for earlier regulatory intervention, prohibiting the sale of specific products, pre-launch product approvals, price-capping, determining specific product features and setting differentiated capital treatment of products.

1.4 In making the general observations and setting out some of our reservations subsequently in this paper, the FOA nevertheless recognises that the FSA will have to become more interventionist, if it is to adequately manage "people risk" and "product risk", but this will need to be handled proportionately.

On the other hand, the FOA notes with concern that there appears to be a degree of inconsistency in FSA's policy approach towards the complexity of financial products and the use of capital rules (see paras 4.3 and 7.5 in this response).

1.5 In particular, the FOA notes and supports FSA's cautious approach towards product regulation, including:

- the intention to *"strike the right balance between consumer protection… and the risks of restricting consumer choice and product innovation"* (para 1.24);

- FSA's assurance that it does not intend to *"act as a gatekeeper for all products entering the market, seeking to eradicate the risks of consumer detriment"* (para 2.20);

- FSA's recognition that *"competition and consumer choice are key aspects of an effective financial services sector"* (para 1.11)

- FSA's recognition that it *"may not always hold the necessary expertise to dictate the best solution to the market"* (para 6.8);

- FSA's recognition, in Sheila Nicoll's 25 January 2011 speech on 'Product Intervention and European Union Engagement', that a more intensive intervention in markets "*will have significant implications for firms and their business models, and we will only do it where we believe other measures will not achieve the outcomes we want"*.

- FSA's emphasis, in its response to the European Commission's Consultation on MiFID, that *"banning products of any kind should be undertaken with great caution, and only in response to specific market failures, as otherwise innovation, effective risk management and economic growth could be detrimentally impacted"*.

The FOA anticipates that these policy statements, if given full effect, will secure a balanced and proportionate approach to product intervention by replacing some of the more radical suggestions proposed in the paper with:

- reliance on pre-notification and discussion on new higher-risk products;

- better use of existing rules and requirements, particularly the Principles for Businesses;

- ensuring that firms have in place the right processes and procedures to negate the need for any direct product intervention, particularly, as it is put in para 2.21, *"appropriate product governance processes to promote fair outcomes for consumers"* and, in para 2.25, *"appropriate systems and controls in relation to product design, product management and distribution strategies"*;

- engaging in direct product intervention only where there is identifiable risk of large-scale, significant customer detriment (see para 1.6(b) in this response).

1.6 In responding to this paper, the FOA would make the following general observations in terms of the scope of the paper and the factors justifying FSA's more interventionist regulatory approach, namely:

(a) that references to *"customers"*, *"consumers"* and *"consumer protection"* are presumed to be references to retail customers and consumers and retail customer protection;

(b) that FSA's objective (and justification) for direct product intervention is, as is stated in some parts of the DP, to reduce *"significant customer detriment"* (and not, as is stated in other parts of the DP, simply *"customer detriment"*) and that any such detriment, as stated in para 1.3 of the DP, must also be *"large-scale"*.

(c) that the stated objective of ensuring *"that new products truly do serve the needs of the customers to whom they are marketed"* takes into full account that customers have very differentiated *"needs"*, which, in turn, require a very wide range of differentiated and often innovative and sometimes complex products;

(d) that FSA will pay continuing regard to the fact – as is recognised by the FSA in the DP – that it should avoid being drawn into any unofficial "kite-marking" or product accreditation in exercising or not exercising interventionist powers;

(e) that, while FSA states that one of its objectives is to avoid the *"high risk of mis-selling"*, product design and mis-selling are distinctive and separate areas of conduct, and while there is a risk that complex products lend themselves (often inadvertently) to being mis-sold, deliberate mis-selling is a specific misconduct issue, i.e. it should not of itself justify product intervention, other than in the form of ensuring that there is proper disclosure of the objectives and risks of investment in the product.

1.7 The FOA would urge the FSA, in terms of the exercise of its more commercially intrusive approach and considering product intervention to:

- pay full regard to the Principles of Good Regulation and what could be a set of new operational objectives (including promotion of competition) and the consequential need for firms to be able to be cost-efficient and secure proper returns on their products and services;

- take into account the fact that FSA's rules and practices will be subject to continuing scrutiny by the Office of Fair Trading, and that a more commercially interventionist approach will necessitate closer liaison with the competition authorities to ensure that it does not have a distorting impact on competition;

- avoid "gold-plating" where possible, taking into account, firstly, that FSA's rule-making capability is being progressively transferred to ESMA and that any super-equivalent rules developed by the FSA should be the subject of an Article 4 report to the European Commission;

- bearing in mind FSA's strong focus on consumer protection, be scrupulous in ensuring that it is objective in its approach to product provision, distribution and intervention and to the treatment of financial service providers.

2. Overview (Chapter 1)

2.1 The FOA agrees with the observation in para 1.10 of the DP that *"the key theme is how improved customer protection should be balanced with a healthy level of choice and competition in the market"* (repeated in para 1.24), but both choice and competition mean, inevitably, innovation.

2.2 The FOA notes in para 1.10 (which is largely repeated in para 1.24) that *"limiting consumer choice"* is acceptable *"when the resulting benefits to the majority of consumers from not being mis-sold a product outweigh the costs to the minority, who might benefit from being able to access it"*. As indicated in the Introduction, the FOA believes, however, that product intervention is less about mis-selling and more about product mis-design and products being "fit for purpose". Whether or not a product is mis-sold is more a matter for business conduct rules and supervision.

2.3 The FOA would emphasise that direct product intervention should be unlikely to be necessary insofar as firms can be expected, as a matter of good governance, to mitigate areas where there is potentially significant consumer detriment, and this is a point which is reflected in FSA's view in para 2.21 that firms should have in place *"appropriate product governance process to promote fairer outcomes for consumers"*.

3. Our New Approach (Chapter 2)

3.1 The FOA would again refer to the fact that the justification for *"rapid action"* by the FSA should be the evidenced risk of *"large-scale"* and *"significant"* consumer detriment.

3.2 While the FOA generally supports the overarching objectives set out in para 2.2, the FOA would question the criterion that *"consumers should be more certain that they are able to purchase financial products designed in their interests"*. The FOA believes that powers of intervention should be driven by whether or not the specific objectives designed to be fulfilled by particular products are met in the product design and not by ensuring that there is an adequate availability of products to meet consumer needs. This would result in a mandate that would cover the need for product issuance which, in the view of the FOA, would not be appropriate for the FSA.

3.3 With regard to para 2.20 of the DP, the FOA welcomes FSA's assurance that it does not see its role as being to *"act as a gatekeeper for all products entering the market, seeking to eradicate the risks of consumer detriment"*. For this reason, the criteria for justifying intervention should, in the view of the FOA, be much more narrowly drawn if the risks identified in this paragraph are to be avoided.

3.4 The FOA agrees with FSA's view that the minimum it expects from firms is that *"they have appropriate product governance processes to promote fair outcomes for consumers"*. The FOA, for this reason, would resist some of the more radical proposals set out elsewhere in this DP. This is otherwise translated in para 2.25 of the DP as to require firms to have *"appropriate systems and controls in relation to product design, product management and distribution strategies"*.

4. The Rationale for Product Intervention (Chapter 3)

4.1 With regard to para 3.6 in the DP, the FOA believes that one of the many problems about information disclosure – likely to be exacerbated significantly by the proposals for additional disclosure obligations set out in the Commission's review of the MiFID – is that key disclosures will go unread as a result of "information overload" and that it is precisely this kind of "overload" that will exacerbate many of the problems identified in para 3.6 of this DP.

4.2 With regard to para 3.14 in the DP, some of the reasons why consumers lack relevant information result from:

- a failure to use plain English;
- key disclosures being buried in the provision of too much information and/or complex disclosure documents;

- consumers not understanding basic financial concepts, which is more a failure in financial education than in product disclosure;

- charging structures can be complex and obscure, and the FSA is right to point out that consumers will focus more on running charges and entry fees, rather than exit fees or contingency fees.

That said, the FOA recognises that it is important that firms adequately train their staff and that product literature strikes a proper balance between potential benefits and risks.

4.3 With regard to para 3.17 of the DP, the FOA does not accept that:

- "past performance" is either "irrelevant" or "less relevant", insofar as it is a key factor in determining performance where it is measured over a sufficiently long period of time and is a true reflection of authentic performance;

- as it is put in para 3.18, *"to some degree, financial products are all complex"* – a statement which conflicts completely with FSA's response to the Commission's Public Consultation on reviewing the MiFID, which stated, at the top of page 67, *"We believe that it is wrong to suggest that all financial services are inherently complex"*;

In addition, the criterion for determining complexity, i.e. the basis on which the FSA's interventionist approach will be "triggered", is far too important to be relegated to a footnote (in this case, Footnote 22). It should be in the body of the paper itself.

4.4 The FOA recognises many of the problems and issues set out in para 3.20-3.30, but would emphasise that some of them would naturally fall to be addressed through FSA's supervisory practices and procedures and do not, in themselves, justify product intervention; others are more a matter for improved consumer education; and others yet may be more readily resolved through the use of plain English and a better focus on key disclosures.

5. The Emerging Supervisory Approach (Chapter 4)

5.1 With regard to FSA's approach to business model and strategy analysis, the FOA would reiterate the importance of taking into full account the need for firms to be competitive (both internationally or domestically), particularly when it comes to assessing performance/risk ratios and targets for business growth. FOA notes that FSA, rightly, states in para 1.11 that *"competition and consumer choice are key aspects of an effective financial services sector"*; and that it is likely that one of FSA's successor bodies, namely, the Financial Conduct Authority, will be subject to comparable operational objectives within the new legislation.

6. Possible Development of the Regulatory Framework (Chapter 5)

6.1 The FOA would urge the FSA to avoid adding greater prescription to existing requirements (other than for cause) and welcomes its recognition that the greater the

prescription, particularly in terms of product intervention, the more the risk that intervention could be construed as an informal form of product "kite-marking".

6.2 The FOA strongly supports the observations in para 5.4 of the DP that *"Our Principles for Business are the starting point"* and would emphasise that many of the concerns identified in this DP are already covered by those Principles (which, of course, take effect as rules).

6.3 The FOA notes that one possibility is to establish *"further high-level rules requiring: identification and appropriate mitigation of inherent risks to customers from the product"*. While risk disclosure is critically important, it must also be fair and balanced. It is important that customers are able to identify and determine accurately what the appropriate risk/reward ratio of products is for them.

6.4 In terms of the more detailed requirements in para 5.17, the FOA would recommend the analysis of any proposed charging structure to be focussed on fair and full disclosure, rather than an obligation that they should be "reasonable".

The last requirement regarding the competency of staff to sign off products should not just be about the qualifications, but also relevant experience.

6.5 With regard to para 5.22-5.23 ("Services"), the FOA notes the suggestion that the approach to "product intervention" could be extended to the provision of services, although it is presumed that this is intended to apply to only retail services.

7. Additional Product Intervention Options (Chapter 6)

7.1 For all the reasons set out in para 6.10 in the DP, the FOA:

(a) does not agree with the option of "product pre-approval";

(b) believes that any powers to ban products should be exercised only on a clearly evidenced basis demonstrating significant consumer detriment risk and with full consideration of the financial and economic consequences that may flow to customers and, of course, to providers and distributors;

NB. The FOA notes that, in its response to the European Commission's Consultation on MiFID, FSA stated that banning products should always be "undertaken with great caution, and only in response to specific market failures, as otherwise innovation, effective risk management and economic growth could be detrimentally impacted". The FOA believes that this view has equal application in the context of this Discussion Paper.

(c) does not agree that the FSA should be able to intervene in matters of price;

(d) is deeply concerned over the use of prudential requirements for achieving policy objectives rather than as a risk mitigant; and

(e) does not agree with proposals to prevent "non-advised sales" and would refer to the FSA's own response to the Commission consultation supporting the continuance of "execution-only" business.

7.2 With regard to para 6.13 in the DP, the FOA supports, in place of pre-approval of products, pre-notification of new high-risk products that pose the risk of significant customer detriment.

The FOA welcomes FSA's recognition that:

(a) it *"may not always hold the necessary expertise to dictate the best solution to the market"*;

(b) the powers as set out in para 6.10 in the DP could generate for FSA *"massive resourcing implications"*; and result in *"the moral hazard of the regulator 'signing off' on a product"* and *"delay to the introduction of new products to the markets"*; and that products banned in one jurisdiction could be readily issued in other jurisdictions where no such ban is in place.

7.3 The FOA is particularly concerned over para 6.20, which seems to change the basis of intervention from, as is stated in parts of the paper, the risk of *"significant consumer detriment"* to what is described in para 6.20 as *"the sale of inferior products offering limited benefits"*. This is a completely different test and one which, in the view of the FOA, seems deeply inappropriate insofar as it would drive FSA towards the very "kite-marking" approach, which, in previous paragraphs, it has sought to avoid.

7.4 The FOA notes in para 6.28 the benefits of using *"less opaque, simpler charging structures"* and would emphasise, in addition, the importance of using plain English to highlight additional periodic charges, particularly exit charges. The FOA believes that this is a preferred approach to benchmarking charges and commissions or imposing price caps. At the same time, the FOA recognises that the FSA may well wish to question some charging structures.

The FOA does, however, have concerns over FSA's view in para 6.36, that the *"starting point for most customers should be a low-charged product"*. This kind of approach could lead to the informal imposition of price caps.

7.5 The FOA notes, in para 6.46, FSA's recognition that imposing increased prudential/regulatory costs on providers could have the effect of reducing returns to, or policy coverage for, customers (in addition to the prospect of other increased "pass-on" costs for customers). The FOA would therefore urge the FSA to be extremely cautious in imposing additional prudential rules that are not authentically risk-based, but designed as a "back-door" means of banning products, i.e. to achieve the objective set out in para 6.46, that firms could avoid *"higher capital requirements by not producing the product"*. The FOA believes that this is a distorted use of the prudential rules. It is noteworthy, in this context, that FSA made it extremely clear that it was against punitive capital charges in the context of OTC business in its response to the Commission's original consultation "Ensuring efficient, safe and sound derivatives markets". FSA seems to be adopting a distinctly contrarian position to such a recently-expressed policy objective.

7.6 The FOA notes, in para 6.47 of the DP, that the FSA takes the view that it could do more to provide *"early warnings about products we regard as posing the risk of*

significant detriment". The FOA would urge that public statements of this nature should not be issued until:

(a) full discussion has taken place between the provider and FSA on the risk/reward ratio of the product;

(b) any public disclosures as to risk (and those akin to health warnings on cigarette packets) are, firstly, wholly justified on a properly evidenced basis and, secondly, reflect a fair and appropriate balance between risk and reward.

It is important to bear in mind that risk and reward are closely interrelated and that customers, on an informed basis, should be able to measure and decide (taking into account any appropriate suitability requirements) on the risk/reward ratios of products. This means that FSA should avoid any prejudiced approach that would distort those ratios or otherwise unfairly influence customers with the capacity and appetite to assume higher levels of risk in order to secure the benefit of greater reward.

The FOA welcomes FSA's recognition over the overuse of warnings and the need to focus on the most important risks (providing they are fairly calculated and expressed in relation to reward), i.e. that "less is more", and that a more simplified approach could have the effect of improving the readiness of consumers to read and take into account any appropriate risk warnings.