

FSA Discussion Paper on Product Intervention

On 25 January, the FSA released its first discussion paper of the year: DP11/1 Product Intervention. The title is blunt, even provocative.

Since the onset of the financial crisis, the FSA has sought to distance itself from its reputation as a light touch regulator and to take “*a more interventionist and pre-emptive approach to regulating conduct*”. *The discussion paper proposes to advance this agenda by restricting or prohibiting the retail sale of certain products.*

The FSA's approach

The FSA's previous regulatory approach “focused on transactions at the point-of-sale”, that is on sales practices, advice and product disclosure. The need for disclosure has long been mandated in respect of products, issuers and securities and the push for greater point-of-sale disclosure and regulation continues, with the UK Retail Distribution Review (RDR), amended Prospectus Directive, Packaged Retail Investment Product initiative and so on.

However, the FSA notes that disclosure “has not always worked as intended: in many cases consumers have reacted unexpectedly to information disclosures, ignored them or not valued them”. The only surprising thing about this might be fact that the FSA feigns surprise, as if they only just realised this – a number of research reports carried out for the FSA in the earlier years of the previous decade had already made this point. However, this seemingly banal statement has a wider significance when put in the context of the ongoing RDR.

Whilst it may be a fact of life that end-consumers to whom disclosures may be addressed may not themselves always take an interest in the pages of risk factors, disclaimers, disclosures, accounts etc that take up the bulk of much product literature – this information does serve a real purpose in informing financial advisers, enabling them to assess the suitability of such products for their clients.

One of the major themes of the RDR is adviser charging and the phasing out of commission based remuneration.



Key Issues

- The FSA and its successor, the CPMA: a new interventionist stance
- Increased focus on the product itself (in addition to disclosure and point of sale)
- The FSA's discussion paper looks at extending the scope of its existing powers



Inevitably this must mean that financial advisers will need to charge their clients more by way of direct fees. Unlike commission-based remuneration, more direct fee structures (with the obvious exception of fees calculated by reference to assets under management) do not significantly vary in accordance with the amounts invested.

In a report prepared for the FSA in 2009 (updated in 2010 and as summarised in FSA Policy Statement 10/6), Oxera, an economics consultancy, noted that advisory firms with less than 10 advisers and with an average client income below £50,000 had indicated that they would leave the market and foresaw an increase in execution only business, as a result of the implementation of the RDR. It is very possible therefore that the consequence will be to make financial advisory services unaffordable by, or simply uneconomic for, clients looking to invest relatively modest sums. Consequently, there is a risk that, for a significant portion of the population, the only affordable

investments will be available on an execution only/non advised basis.

In such a scenario, public profile and advertising spend may have an even greater impact on investors' decision making processes, whilst, with the advisers taken out of the equation, disclosures and "small print" really does seem to serve a very limited purpose.

So, deprived of the usefulness of disclosure by its own assault on adviser charging the FSA may consider itself to have left itself no option but to refocus on "intervention earlier in the value chain" – i.e. to become more directly and intrusively involved in the product development process itself.

Arms Parade and Arms Race

So, how is the FSA to intervene?

The FSA parades its current enforcement arsenal in the discussion paper, including its rights to impose penalties and its rights to vary and cancel regulatory

permissions. The FSA anticipates increasing its use of these "to develop [its regulatory] agenda and encourage market change". None of this is surprising, being pretty much a necessary consequence of the FSA's tougher approach, and is already being demonstrated by the FSA's recent actions.

However, the FSA goes further and details a number of "additional product intervention options", many of which are outside the scope of its current legal powers: product pre-approval, banning products, banning or mandating product features, price interventions, increasing prudential requirements, consumer/industry warnings, preventing non-advised sales and additional competence requirements.

Whilst noting that "the government has indicated that, where appropriate, it will enhance [the CPMA's] supervisory and enforcement tools... to ensure that the new authority can deliver its role as a credible conduct regulator", the FSA does not specify the legal basis of such powers.

Product Pre-Approval

The FSA is clear that, in light of major cost and other implications, it is not proposing a requirement for all firms to have their products pre-approved. Or rather, it is not at this time so proposing. Is this a threat?

The FSA cautiously raises the possibility of requiring targeted pre-approval for specific product-types or firms. Although the FSA sees difficulties with this approach, it could serve as a sobering threat for firms or product sectors that the FSA.

As a more viable, quasi pre-approval measure, the FSA suggests a requirement for firms to pre-notify the FSA of any new products, or changes to

existing products (which could of course be limited to certain product-types or firms). The FSA refers with some admiration to the Malaysian Central Bank's pre-notification regime for products new to the Malaysian market. Significantly, the FSA notes that such regime could be implemented with minimal changes to the existing FSA Handbook: clearly the FSA sees such steps as well within their given powers.

There is no suggestion whatsoever that the FSA intends to introduce the nuclear option of an absolute pre-approval regime at present, nor does it seem keen to introduce widespread selective pre-approval requirements. However, by pointing out the relative ease with which it could implement a pre-notification regime, and by framing it as tantamount to a pre-approval-lite regime, and in the context of the FSA's obvious posture of disappointment with firms' self governance, the FSA is clearly making a veiled threat nonetheless that, given the necessary resources, it may eventually be driven to obtain and use the harsher powers.

Product Bans

The FSA also mentions the fact that it might be willing to consider banning products that it considers to have the potential to cause significant detriment. As with pre-approvals, the FSA raises this with a degree of caution – however, the threat is definitely there. Moreover, the FSA is less restrained in its proposals with regard to banning limited product features.

The concept of a product ban raises interesting questions about precisely where the FSA sees the limits of its powers. The European Commission, in December's MiFID Review consultation, envisaged that national regulators might ban products in "exceptional adverse

developments which constitute a serious threat to financial stability or to market confidence".

In reality, the power to ban a product, is tantamount to the power to regulate it and we would expect authority for such discretion to be enacted in primary legislation. Does the FSA purport to have the powers to implement such a ban itself, or is this a power the FSA believes would need to be granted by the legislature? The FSA does not specify.

Any such power would give the FSA broad discretionary power. Precisely which products would the FSA choose to ban and how would any product developer genuinely be able to predict what may or may not incur the FSA's wrath?

The discussion paper elsewhere sets out a table of indicators of problematic product features, but these are neither exhaustive and nor are any of them necessary determinative of a "bad product". Whilst the FSA feels the need to be prescriptive, it also recognises the limitations – indeed impossibilities of defining "bad" products in any kind of comprehensive and meaningful way. It really is a case of different products having different uses for different people.

Although the FSA acknowledges there are drawbacks involved in banning products, one important point it fails to mention is the effect on consumers' ability to liquidate their positions in subsequently banned products.

In short, the power to ban (and indeed, the requirement to pre-approve) any product would give the FSA (or rather, its successor, the CPMA) incredibly broad discretionary powers, and the industry (and consumers) would need to hope such bodies are benevolent and proportionate in their use of such power.

An Escalating Threat?

The FSA is positioning itself (and the CPMA) to take an aggressive and intrusive approach to product regulation itself, an area which has previously taken a back seat to regulation of point-of-sale practices and disclosures.

The FSA clearly is not satisfied with all firms' product governance processes and claims it will police these rigorously, whilst boasting of its current ability to take a wide range of enforcement actions where such processes fail to produce products with which the FSA is satisfied. Moreover, with the likely increase of non-advised investing, the effectiveness of product disclosure is increasingly in question, leading the FSA to the conclusion that it must intervene earlier in the product value chain and to seek out the tools better to enable it to do so.

Whilst some of these tools raise interesting legal questions, in light of the ongoing popular desire to rein in the financial services industry, and the FSA's heated rhetoric, even the more extreme measures cannot be altogether easily dismissed.

The consultation period on the discussion paper ends on 21 April 2011.

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