

Retail Product Development & Governance: is your process in place?

The FSA continues its review of the retail structured product market with the release this month of its paper “Retail Product Development & Governance – Structured Products Review”. It is clear that the FSA’s theme of product intervention is here to stay – with the FSA reminding firms that its successor the Financial Conduct Authority (the “FCA”), will adopt the same approach when it takes over the reins.

What does the guidance cover?

The guidance provides a further insight into the FSA’s views on the responsibilities of product providers and distributors, a topic which has had a continued focus from the FSA over recent years, whilst at the same time, re-emphasising the regulator’s focus on a more interventionist approach (albeit this time looking at the earlier stages of the product life cycle). The guidance included in the paper comes in the form of setting out practical examples of the systems and processes the FSA expects firms to maintain when producing and marketing structured investment products and structured deposits.

The paper also reminds firms on the application of the Unfair Terms in Consumer Contracts Regulations (1999) (the “**UTCCRs**”) which apply to standard form consumer contract terms which have not been individually negotiated with consumers. Whilst only a court may determine the fairness of a term under the UTCCRs, the FSA has used this an opportunity to set out its views on the types of terms which they consider could be deemed unfair. It is important to note that whilst the FSA may not conduct enforcement proceedings against firms under the UTCCRs, the regulator would take into account the guidance provided in this paper when using its powers as a ‘qualifying body’ under the UTCCRs. Therefore the FSA would be able to challenge firms that use unfair terms

and/or terms which are not written in plain and intelligible language.

Finally, the FSA has taken the opportunity to remind firms on the application of both the Collective Investment Scheme Sourcebook (“**COLL**”) and the Prospectus Directive where applicable, including the upcoming changes resulting from the amendments to the PD regime to take effect in July 2012.

When does the Guidance come into effect?

The paper covers a number of topics with a third of the paper (e.g. proposed guidance on product development and governance and commentary on the prospectus rules) constituting guidance

subject to a consultation period ending on 11 January 2012. The guidance on the UTCCRs comes into effect immediately.

What the FSA expects from your process

This guidance consultation reiterates that the FSA expects firms to have read and be familiar with its communication ‘*The Responsibilities of Providers and Distributors for the Fair Treatment of Customers.*’ In addition, there is an expectation for firms to focus on the Principles when developing new structured products, this includes both structured investment products and structured deposits.



What is clear is that the FSA expects firms to build on the general guidance and principles provided in the past by the FSA, to ensure that firms implement robust systems and controls when

developing new retail structured products. To assist with this task, the FSA has set out eight stages that firms should consider when embarking on the process of launching a new structured

product. The table below aims to highlight some of the key 'actions' that the FSA recommends to firms.

Product Approval Procedures	<ul style="list-style-type: none"> ■ Ensure an appropriate approval process is in place for the type of product being launched. Checks should be in place for when a 'light process' may be used by firms for reviewing similar new products to existing products or when a new process should be adopted. ■ Implement a review process for changes in the market and potential for product creep.
Product Development	<ul style="list-style-type: none"> ■ Ensure consumer research focuses not just on profitability and the commercial outcome for the firm but adequate focus is placed on consumer needs and wants. ■ Identification of the target market or audience is crucial. ■ Advised sales teams must recognise the importance of suitability when assessing products for clients. ■ <i>"Where advisers do not understand products, they should not recommend them"</i>
Design & Development of Product Features	<ul style="list-style-type: none"> ■ Design process must take into account consumers' different needs and attitudes to the preservation of capital and access to compensation arrangements. ■ Firms must ensure that product features that are visible to the consumer are likely to be understood by the product's target market, (i.e. consumers can see where their pay-off is designed to come from & assess the likelihood of receiving it). ■ The design process should take into account: (a) the distribution of the total gross returns of the product and whether this is fair to the consumer; (b) possible recourse to the FSCS; (c) the distribution channel; and (d) the tax implications of the product's pay-off. ■ Contract Terms: contracts must be clear and fair and accurately reflect the features of the product. (See the UTCCR analysis below for further information).
Stress-testing and modelling	<ul style="list-style-type: none"> ■ Given the limited value of 'past performance, stress-testing should be forward-looking as well as back-tested. ■ Simulations should be carried out to understand the expected profitability from the investor's view and those outcomes should be graded in terms of probability. ■ Collateral management (for structured investment products) should form part of a robust process in prudential management and should be well documented.

<p>Marketing – distribution and communications</p>	<ul style="list-style-type: none"> ■ Firms with wholly intermediated distribution strategies have a significantly higher risk profile. The FSA has identified restricted distribution through one (highly trained) channel for complex products as a method by which firms could mitigate this risk. ■ Where a structured product has particularly complex features, firms should take care with the use of non-advised distribution. ■ Product providers should consider consumers at the end of the supply chain – i.e. think beyond the distribution chain. ■ Firms should carry out due diligence on distributors, which should then be assessed regularly.
<p>Information to distributors</p>	<ul style="list-style-type: none"> ■ Firms need to ensure that distributors are given sufficient levels of information to understand complex products – this may differ from the type of information provided to the consumer. ■ Financial promotions are not sufficient to meet a firm’s obligations and firms may need to provide further technical detail to distributors. ■ Firms should consider providing training to distributors where appropriate.
<p>Information to consumers</p>	<ul style="list-style-type: none"> ■ Firms should consider the complexity of a product and how they can explain this to a consumer without misunderstandings taking place. ■ Firms should promote the features of the products in a fair and balanced way. ■ Structured deposits should display AERs clearly and prominently.
<p>Post-sales responsibility</p>	<ul style="list-style-type: none"> ■ Firms should perform periodic reviews to ensure that their product continues to meet the requirements of their target audience. For example, the guidance highlights a scenario where a firm having seen the effects of the global markets in 2009, took steps to re-design a structured investment product to better meet the needs of the consumer, whilst at the same time clearly communicating their proposals and change of strategy to the consumer. ■ Firms should be able to clearly articulate the criteria that are used when post-sales assessments are made. ■ Firms should ensure they treat consumers fairly throughout the life of a product and ensure they have the appropriate systems in place to meet their obligations.

UTCCRs

As part of its review, the FSA has identified three types of terms which it believes are likely to be classed as 'unfair' under Regulation 5¹ and/ or are not, in the FSA's view, expressed in plain and intelligible language in accordance with the requirements of Regulation 7².

Exit Terms

These terms usually require a consumer to either pay a fee in order to exit the contract early (i.e. an early redemption charge) or that on exit, the firm would sell the underlying securities in the structured product and refund the proceeds of the investment to the consumer.

The key observation from the FSA is that firms need to be more transparent as to how these charges may be calculated. For example, firms should explain in a clear manner how such charges may be calculated and place such information in one section of a contract as opposed to spread across a number of different terms. Finally, firms should ensure that the consequences of early withdrawal are set out clearly whilst explaining the differences between charges for a partial withdrawal or transfer.

Termination Terms

In the FSA's view, such terms should not permit firms to have a broad discretion to terminate the contract as a result of a consumer's breach and that any such discretion provided under the terms should be causally linked to the materiality of the consumer's breach³.

Variation Terms

A variation clause is less likely to be regarded as unfair if it can only be made with a valid reason specified in the contract. However, even in such instances such reasons must be assessed in the light of the UTCCRs as a whole – for example prior notice to consumers may need to be provided prior to varying terms in a contract. Such steps would assist firms in mitigating the risk that a term may be rendered void.

Brochures accompanying terms

The FSA draws attention to instances where brochures are provided to consumers alongside terms and conditions and information in the former is referred to in the latter. The FSA suggests that any reference to the accompanying brochure in the terms and conditions should be provided in the form of clear links and/or references to the brochure itself.

However of more concern is the FSA's final point (to which the answer is not clear at all) that on the question of whether the brochure would then be assessable under the UTCCRs, the FSA surmises that firms may wish to 'bear this in mind' when drafting terms and conditions and/ any accompanying brochures. This can only lead to the conclusion that firms should only refer to such brochures where absolutely necessary.

Useful links

FSA Guidance Consultation on Retail Product Development and Governance – Structured Products Review:
<http://fsahandbook.info/FSA/html/handbook/RPPD>

FSA Responsibilities of Product Providers & Distributors Regulatory Guide:
<http://fsahandbook.info/FSA/extra/4720.pdf>

TCF Library:
<http://www.fsa.gov.uk/Pages/Doing/Regulated/tcf/library/index.shtml>

The Unfair Contract Terms Regulatory Guide:
<http://fsahandbook.info/FSA/html/handbook/UNFCOG>

¹ Regulation 5 provides that a term will be unfair if "contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract to the detriment of the consumer."

² Regulation 7 states that a firm "shall ensure that any written term of a contract is expressed in plain, intelligible language" and "if there is doubt about the meaning of a written term, the interpretation which is most favourable to the consumer shall prevail."

³ See published undertaking on this topic: http://www.fsa.gov.uk/pubs/other/undertaking_nab.pdf



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