

JOINT RESPONSE TO THE FSA'S DP06/4 ON THE RESPONSIBILITIES OF PROVIDERS AND DISTRIBUTORS FOR THE FAIR TREATMENT OF CUSTOMERS.

EXECUTIVE SUMMARY

This Response to the FSA's Discussion Paper 06/4 has been prepared by **ESF, ICMA, ISDA, LIBA** and **SIFMA**, on each of which further information is provided at the end of this Executive Summary. Members of these associations are involved in the Retail Structured Product market in a number of ways and this response is informed by a dialogue within firms between provider and distributor functions.

The Associations are delighted to be able to respond to this Discussion Paper, which enumerates important issues in relation to a valuable and growing market in a timely fashion. As the Paper acknowledges, firms have been focusing on these issues in informal industry gatherings and this has allowed debate to progress significantly, which is reflected in the current response. The issues, however, are many and complicated and in our view require very careful analysis. In fact, we seek further dialogue with FSA on the basis of the points raised in the current response, before the Statement is finalised and as regards possible future work on confirming standards in the RSP market that may prove to be helpful. Specifically, we are interested in exploring the extent to which industry might usefully provide clarification on good practice, in line with the new confirmation-of-guidance procedure envisaged in DP06/5.

We note in this regard our continued support for the approach adopted as a result of the discussion process initiated in 2005 on 'Wider-range Retail Investment Products' (DP05/3 and FS06/3).

Throughout our response and consistent with the thrust of the current Discussion Paper, references to investor should be taken as references to individual, retail customers.

I. Principal issue

We summarise below some of the salient points from our response but wish, above all, to stress the following: there is a strong case for concluding that, at least where retail structured products are concerned, it is provider and distributor firms themselves that are best placed to determine what the correct division of responsibilities should be in any given situation, such that those responsibilities are fully covered. This is in large part because a variety of arrangements can apply in relation to the origination and sale of retail structured products (RSPs), depending on factors such as the parties, the product, the jurisdictions and the investors involved. These arrangements between provider and distributor can vary considerably from the somewhat limiting stylised example (involving a 'retail manufacturer') provided in Annex 2 of the DP (and we believe that Annex 1 should explicitly recognise this fact).

We note, moreover, that the reputational incentives for firms to clarify the nature of the relationship between a provider and distributor are strong and that this is in practice commonly carried out by firms active in this market.

We are, therefore, concerned that the Statement – despite its laudable intentions – appears to create new responsibilities, which go beyond the MiFID and which interfere with private contracts between parties (ie, provider and distributor). We believe it is helpful for the FSA to stress key principles, but that the logical and desirable corollary of this is that industry should put

this into practice as appropriate, and that the example-driven approach of the Statement may interfere with this process. Nor, in our view, should generalisations be made on the basis of very specific examples.

To quote from the body of our response:

“In broad terms, we believe the sensible starting point is to begin from the proposition that the different participants in the distribution should apply their expertise to the area in which they have it, should be permitted to rely on each other to apply that expertise appropriately and in particular should not be responsible for the discharge by each other of their respective regulatory responsibilities, and should be free to decide as between themselves how this outcome is best achieved. Provided that this agreement is comprehensive (in the sense that every aspect of the consumer's requirements is considered and appropriately addressed by the arrangement), there is no reason why it should not be accepted by the FSA. While they may be of some help in illuminating issues for consideration, we do not ultimately believe that applying paradigms generated in a different legal context in respect of different products is likely to benefit consumers in this area.”

In line with this facts-of-the-arrangement approach, we suggest that the Statement should outline that the distributor and the product provider should have:

- undertaken a process by which they have collectively considered the position of the consumer;
- agreed between themselves which of them would be responsible for which aspects of the sale and after-sale care of the consumer;
- recorded the outcome of that consideration; and
- enabled the consumer to be aware of which entity they could turn to with any queries.

We believe that, because the approach in the draft Statement diverges (as outlined above) from the approach that industry would prefer, the Statement potentially creates new responsibilities in relation to the five key areas set out in paragraph 3.1 of Annex 1, namely:

suitability assessment (*see para 32 ff of our response*);

choice of distribution channels (*para 39 ff*);

information provision (*para 41 ff*);

monitoring (*para 45 ff*); and

post-sale service (*para 48 ff*).

II. Overall response

As regards our response more broadly, the essence is as follows:

- RSPs are capital market instruments and, as such, fundamentally different from the more traditional instruments treated in DP06/4 (such as life assurance), where the product provider may indeed be expected to have some relationship with the consumer and where the distributor may be little more than an introducer. RSPs function like securities, with the consumer being a customer of a broker or other adviser. This distinction is not clear in the DP.
- there is no single, universally applicable model of retail distribution arrangements, which makes it extremely unlikely in our view that principles can be developed that are either sufficiently general or sufficiently specific. The Statement seeks to generalise across the customer experience involved in a series of different types of transaction. However it appears to us that customers are aware that different terms pertain to the distribution of different products. We therefore do not believe that the state of relationships as regards any one product distribution channel is necessarily of any great help in determining the proper state of relationships in another. Again, we believe that the Statement should explicitly acknowledge this state of affairs.
- very few firms ever fall neatly into one of the two buckets set out in the DP – pure (and unwitting) providers on the one hand and, on the other, pure retail manufacturers who simply purchase what might be called ‘pre-fabricated components’. There is more typically an iterative process by which the two sides aim to marry up their respective relative strengths (on the investor and wholesale market side) to create a viable product.
- the cross-border dimension of the RSP market is significant and the effects on cross-border competition of FSA pronouncements should be reviewed with this in mind. There is a clear possibility of competitive disadvantage for UK authorised firms if supervisors in other jurisdictions do not introduce similar requirements. This disadvantage would apply in two ways: as regards business conducted in the UK (since overseas providers would not face the same regime); and as regards business conducted overseas (in which London-based providers can and do play a significant role but could be subject to extra-territorial application of the Statement). Please see paragraph 13 of our response for a fuller discussion of this issue.
- while we welcome the fact that the DP focuses to a significant extent on principles (rather than, say, new regulation), it is important to clarify the status and the force of the proposed pronouncements. At one stage DP06/4 refers to the possibility of enforcement (paragraph 1.13) and industry believes this is at best premature, especially as the DP seems – in practice if not in intent – to suggest some change in the obligations falling upon firms. Depending on the status and force of the Statement, proper cost-benefit analysis would then be a relevant issue.
- RSPs may be complex for firms to put together but it is their risk-reward profile that matters where the consumer is concerned. Any inference that customers should be segmented based on their familiarity with these products is therefore not helpful, as it assumes that a) the instruments have a uniform risk-reward profile and b) investors have uniform investment objectives and risk tolerance. This is demonstrably not the case.

In summary then, we urge caution in finalising the Statement, given that the end-result may not be consistent with the stated aim of enunciating fundamental principles (and not changing the current position). Accordingly, we seek further dialogue on how best to proceed in relation to an area which does not lend itself easily to the sort of generalisations attempted in DP06/4.

The respondent Associations



The European Securitisation Forum (**ESF**) is a 160-member association comprising leading participants in all sectors of the European securitisation, structured products and CDO industries. Participants include issuers, investors, arrangers, rating agencies, lawyers and accountants, stock exchanges, trustees, valuation providers and information services. The ESF is a forum of the Securities Industry and Financial Markets Association, which is described below, and shares its mission.



The International Capital Market Association (**ICMA**) is the self-regulatory organisation representing the financial institutions active in the international capital market worldwide. ICMA's members are located in some 50 countries across the globe, including all the world's main financial centres, and currently number over 400 firms.



ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA (the International Swaps and Derivatives Association) was chartered in 1985, and today has over 725 member institutions from 50 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Information about ISDA and its activities is available on the Association's web site: www.isda.org.



The London Investment Banking Association (**LIBA**) is the principal trade association in the United Kingdom for firms active in the investment banking and securities industry. The Association represents the interests of its Members on all aspects of their business and promotes their views to the authorities in the United Kingdom, the European Union and elsewhere. For more information, please visit www.liba.org.uk.



The Securities Industry and Financial Markets Association (**SIFMA**) is a trade association that results from the November 1, 2006 merger of the Securities Industry Association and The Bond Market Association. It brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests in the US and globally. It has offices in New York, Washington DC, and London and is associated with the Hong Kong based Asia Securities Industry and Financial Markets Association.

FULL RESPONSE

1. Institutions which are members of the group of respondent trade associations are involved in the retail structured products markets in a number of ways; as providers of derivatives through the wholesale markets, as issuers of structured products (usually, but not always, in securitised form) and sometimes as distributors. Different parts of these institutions approach this business in different ways and have different regulatory concerns. Many institutions have sought to achieve consensus internally between their origination and distribution functions, and this paper draws on the output of this process. Consequently, it is informed by extensive discussion between originators and distributors.
2. The institutions which form the group are committed to the development of a retail structured products market in which appropriate products are sold to informed (retail) investors in a fair and transparent way. Their collective belief is that the development of the retail structured products market presents an opportunity to offer to retail customers products which give them the ability to diversify and to tailor their risk exposures in accordance with their risk appetites. They therefore wish to see the market develop on the basis of good standards and levels of transparency and customer protection. They are aware that the delivery of these outcomes is an essential prerequisite for the market to continue to grow.
3. As part of this agenda, some of the institutions who have contributed to this response have been working together, both with each other and with distributors, to identify and promulgate current industry practices. This is a continuing initiative, and the FSA decision to consult upon a draft Statement (the "**Statement**") is a helpful contribution to it. The group therefore welcomes the FSA's initiative in this area. We are particularly pleased that the FSA has decided to proceed by seeking to highlight and promulgate existing market standards rather than by imposing formal regulation. The development of complex and formulaic regulation would be likely to damage (or at least restrict the growth of) this market, and the group's members are therefore pleased to see that the FSA is approaching this issue using a principles-based approach. It is particularly to be welcomed that the Statement is described as being intended not to add any new regulatory responsibilities, either for providers or distributors, but to set out existing responsibilities. Although we do not believe that the current draft of the Statement entirely achieves this aim, we broadly concur with the FSA's overall objectives, and wish to work with the FSA to produce a useful and effective Statement.
4. Because of the nature of securities distribution, the sale of securitised retail structured products will usually involve multiple participants, and the distributor will usually be a different person from the originator of the product. We agree wholeheartedly that the ultimate aim of the project should be to get to a situation where "A customer's experience should not be affected by whether a product was provided and distributed by a single institution or by two or more institutions." (para 1.5) Throughout this response, our focus is on retail consumers and all references to investors are to be taken as references to such consumers.
5. We believe that the most useful contribution that the Statement can make to the market at the moment is to encourage enhanced co-operation and exchange of information between originators and distributors of products. The primary responsibility for ensuring that the retail customer buys a product which is appropriate for his needs and meets his requirements for risk exposure and return rests firmly on the distributor. However, there is clearly scope for

providers and distributors to work together to ensure that this outcome is achieved. To the extent that the Statement encourages this development, it will have made a valuable contribution to investor protection.

6. You have asked for responses to four specific questions. We have responded to these in order below.

Question 1: Do you agree that this Statement accurately reflects the respective responsibilities of providers and distributors under the Principles?

7. Group members have, individually and together, done a considerable amount of work with distributors with the aim of ensuring that any discontinuities between the expectations of providers and distributors as to customer responsibilities are identified and eliminated. The essence of this work has been based on the twin principles that:

(a) the distributor and the originator should confirm between themselves the areas for which each is responsible; and

(b) the retail consumer should be provided with information which enables them to be aware as to which entity they should turn to with any queries..

We believe that these two principles constitute the correct foundation for determining the responsibilities of providers and distributors.

8. Although the current draft of the Statement does not purport to change the existing regime, it is important to realise that there would be very significant ramifications for the industry if it were to be promulgated in its current form. This is because it appears to propose significant departures in some respects from existing arrangements between providers and the distributors, going beyond what providers, distributors or (retail) investors have agreed or required in the past. Also, the territorial scope of the Statement is obscure and needs to be clarified – as currently drafted it could make it extremely difficult for providers in London to deal with distributors who are outside the jurisdiction of the FSA.
9. We also note in passing that there is a considerable amount of material currently in circulation relating to the fair treatment of customers. It would be helpful if, in final form, this Statement were to make clear that it encapsulates and supersedes the relevant parts of all such material on this topic.
10. The roles of the product provider and distributor are affected by a large number of considerations, including the type of transaction, size of the parties, jurisdiction of the parties, expectations of the end investor, contractual obligations of the parties, legal and regulatory obligations of the parties and the ability of certain parties to perform certain functions. In most of the examples given in the Statement, there is a high reliance by the end investor on the product provider (due to the direct interface between the provider and the retail customer). That is extremely rare in practice in the securitised structured retail products arena or in cases where the product provided is a derivative that is purchased by a retail product manufacturer for inclusion in a product sold by him. We therefore believe that the different participants in the retail distribution process should apply their expertise to the area in which they have it

and where they have the requisite information, that they can rely on each other to apply that expertise appropriately and that they should not be responsible for discharging each others responsibilities.

- 11.** There are a number of areas where we are concerned that the Statement could have unintended adverse consequences. One of the most important of these relates to its intended geographical scope. The Statement seeks to clarify the FSA's understanding of the responsibilities of UK-regulated product providers and distributors and it appears to us that the aim of the Statement is to protect retail consumers in the UK. However, it raises significant cross-border issues. The fact that the Statement is presented as an elaboration of obligations imposed by the Principles gives it an extra-territorial application, since in theory the obligations imposed by the Principles apply to all of the activities of UK-regulated firms worldwide. The retail structured product market is a global market, and in particular the market in certain EU member states plus Switzerland is very significant (while the UK domestic market represents a fairly small proportion of the EU retail structured products market). However, many of the major players in these markets are based in London. Thus, if the standards set out in the Statement were to be applied as an elaboration of the Principles, they would have extra-territorial effect for UK based product providers, since they would purport to govern their dealings with distributors in France, Germany, Italy and other EU jurisdictions, as well as Switzerland. Since no other jurisdiction has sought expressly to apply explicit standards on product providers or distributors in the way set out in the Statement, this could constitute a very serious detriment to UK-based firms, particularly because we also have concerns that the Statement could amount to a gold plating of MiFID (see below). Equally, the Statement does not apply to non-UK firms exercising their rights to carry on business on a cross-border basis into the UK (or, indeed, into competing markets in EU member states or Switzerland). As indicated above, if the standards applied in the Statement are higher than those applied by regulators in other jurisdictions, then UK-regulated firms will be put at a potential disadvantage as against firms operating from those states. We therefore believe that the FSA needs to consider the potential extra-territorial impact of the Statement very carefully. The combination of the factors highlighted above raises the prospect of some firms moving activities out of London and into Switzerland or member states that do not apply the same standards. We do not believe that this is the policy intention of the FSA, and suggest that in the final text of the Statement a provision is incorporated to the effect that the Statement is specific to domestic UK distribution and that the standards set are reviewed very carefully to ensure that they do not materially exceed those that other member states are likely to apply to firms passporting into the UK on a cross-border services basis.
- 12.** Similar issues arise in relation to the production of product materials for use in some member states where there is a concern that, for example, under the Prospectus Directive regime some local regulators may simply not allow the inclusion of the level of information in product materials that providers might feel necessary to include as a result of the Statement. There are also concerns that national laws regarding responsibility for securities offering materials may be inconsistent with, and potentially contradictory to, the provisions contained in the Statement. For example, it is difficult to see how the Statement is entirely compatible with the FSA's Prospectus Rule 5.5, in particular sub-rule 5.5.5.
- 13.** We are also concerned by the observations in para 1.13 and 1.14 of the Statement, which appear to be incompatible with the stated aims of the FSA in the remainder of the Statement and with the approach which has been applied to its promulgation. The particular areas which

give cause for concern are that the FSA takes the view that changes in firm's behaviour are needed in respect of compliance with the existing principles in this area, particularly when this statement is taken in conjunction with the statements in para 1.13 concerning enforcement action. If the FSA considered that firms were in widespread breach of fundamental principles, this would be a matter of great concern to firms generally and would be likely to trigger remedial action. However, these observations are incompatible with the other parts of the Statement, in particular:

- (a) the observation in para 1.11 that the Statement is only intended to set out existing responsibilities;
- (b) the fact that the Statement does not set out or identify any particular area in which such widespread and general breach can be identified; and
- (c) the fact that the Statement has not gone through the FSA guidance-giving procedures required by s.157 of the Financial Services and Markets Act 2000. We would expect any Statement published or to be published by the FSA which has the effect of significantly altering the obligations of regulated firms to be subjected to the process disciplines of the FSA's policy-making functions, and in particular to be subject to a cost benefit analysis and a publication of the reasons for the making of the proposed change as required by s. 155(2) of the Act.

We believe that FSA should resolve this issue by stating clearly and publicly whether the Statement is intended to have a significant effect on the obligations of member firms. If it is, then the s.157 processes should be followed. If it is not, then the references to the publication of the Statement altering the enforcement position should be withdrawn.

- 14.** The Statement seeks to generalise across the customer experience involved in a series of different types of transaction. There is clearly something to be said for this. However, it appears to us that customers are aware that different terms pertain to the distribution of different products – thus, a customer buying a share through a stockbroker would have a different legal relationship with the stockbroker from that which a customer buying a life policy would have with an IFA intermediary. We therefore do not believe that the state of relationships as regards any one product distribution channel is necessarily of any great help in determining the proper state of relationships in another. Put another way, there is no single model of retail distribution relationships which is universally applicable to all cases and all circumstances, and we do not see how any detailed proposals could be created in such a way as to be both sufficiently specific to provide guidance on individual relationships and sufficiently general as to be universally applicable across this entire product universe.
- 15.** None of the examples given in Appendix 2 of the Statement is of a mainstream advised sale or discretionary management arrangements in the form usual in the securities industry. Consequently none of these examples fully address the facts of a normal retail structured product sale. Where, for example, a customer is advised by his stockbroker or private bank to subscribe for a new issue of shares by a listed investment entity (such as an investment trust), that investment entity does not have (and cannot have) an obligation to assess the suitability of the shares for individual clients of the bank or broker, since the nature of the arrangement

is that the customer's primary and continuing relationship is with the distributor¹, not the issuer. The key point here is that the customer begins with a clear understanding (provided by the distributor) of what the issuer or originator will do and will not do, and makes his arrangements with the distributor in the light of that information.

16. The closest of the examples to actual practice – example 5 – incorporates the concept of a "retail manufacturer" who has sole responsibility for the design of the product. Although this does occasionally happen, the usual structure would be that distributor and originator would discuss between themselves the broad outline of a product, and that the final product terms would be arrived at as a result of this discussion. It is only very rarely that a single party will take on complete responsibility for the structuring of a product so as to fall within the "retail manufacturer" category².
17. In this context we note, however, that the category of pure manufacturer of component products is a helpful one, and the analysis in respect of this activity is broadly correct. It is important that a market participant should be able to deal freely with a retail institution without being affected by rules relating to the treatment of products which the market participants transaction may have hedged – any other approach would have the effect of restricting retail institutions' access to the market, increasing their hedging costs and providing worse returns to retail consumers.
18. Each of the types of retail product considered in the annexes is distributed in a different way; is subject to a different balance of regulatory obligations; and in each case the customer has different expectations as to the roles of distributor and provider. The obligations of distributor and provider as regards any particular transaction need to be determined in the light of a number of factors specific to that transaction, including:
 - the expectations of the customer;
 - the contractual obligations of each participant to the customer and between each other;
 - the existing regulatory obligations of the different participants (which still vary significantly between product types); and
 - the ability of certain participants to perform certain functions (e.g. distributors may not have the technical skills to do complex stress testing, providers may not have the information to do customer segmentation or suitability analysis).

In broad terms, we believe the sensible starting point is to begin from the proposition that the different participants in the distribution should apply their expertise to the area in which they have it, should be permitted to rely on each other to apply that expertise appropriately and in particular should not be responsible for the discharge by each other of their respective

¹ It may be objected that the sale of investment trust shares is not a significant part of the retail structured product market. However, the majority of the products distributed in the UK in this space are modelled on, and owe their origins to, products developed to be sold in this space.

² We continue to use the term 'retail manufacturer' elsewhere in this response, but only as a convenient label for firms who perform some role which, to a greater or lesser extent, disintermediates the wholesale provider from the customer and the sale to that customer.

regulatory responsibilities, and should be free to decide as between themselves how this outcome is best achieved. Provided that this agreement is comprehensive (in the sense that every aspect of the consumer's requirements is considered and appropriately addressed by the arrangement), there is no reason why it should not be accepted by the FSA. While the examples may be of some help in illuminating issues for consideration, we do not ultimately believe that applying paradigms generated in a different legal context in respect of different products is likely to benefit consumers in this area.

19. The trade association groups to which the Statement refers in para 1.14 have engaged in an initiative to perform an analysis in respect of the distribution of securitised structured products. These initiatives have involved a number of meetings among representatives of both product providers and distributors in relation to structured retail products. These meetings have permitted extensive discussions among the participants in which a broad consensus is emerging around certain points. We believe it is helpful to set these out here as they can form a useful starting point for the development of an understanding of the accepted responsibilities and customer expectations which exist in this area. Although they are framed in terms of product providers and distributors, an important element in understanding the respective responsibilities of those involved in the production and distribution of retail structured products is the intermediate role played by the retail product manufacturer – a role acknowledged but arguably not given enough attention in the Statement.

1. Distribution to the retail purchaser of securitised retail structured products is generally through intermediaries, such as private banks, rather than directly by the product manufacturer.
2. Where a product manufacturer and a private bank (or other retail-facing business) operate within the same institution, they will generally operate distinctly, be subject to different regulation, and have different reporting and management structures. This separation is generally robust and will be driven by legal, compliance, confidentiality and other requirements. Thus even where a product is originated and distributed by the same institution, there will usually be a separation between the manufacturing and distribution function to which these principles should apply.
3. Product providers should have formal internal approval processes for retail structured products.
4. The distribution structure means that it is the distributor who interfaces with the investor and whose client that investor is. Investor suitability is exclusively an issue for distributors, since it must be considered in the context of confidential information provided by the client to the distributor
5. Distributors must understand the product. Where a distributor provides termsheets or other material to their clients, those materials are their materials, even if they incorporate material provided by the product provider. This means that a distributor must be satisfied with and take responsibility for the accuracy and the compliance of such materials with local law and regulation.
6. Product providers should ensure that their termsheets and other materials are consistent with their agreed obligations to the distributor. For example, where the parties understand that the product will be distributed by the distributor to high net worth individuals, the termsheet should not contain rubric that the product is not suitable for individual investors. Providers should assist the distributor by providing information which is clear and of the kind requested by the distributor in preparing its

- own termsheet or product description for its client. This may include scenario analyses and relevant to product risk factors.
7. Product providers should undertake "Know your distributor" approval processes, with a view to satisfying themselves that the distributor is an appropriate distributor for the placing of the product. The determination will often include consideration of a distributor's typical client type, suitability determination processes, reputation and compliance with selling laws, but this will vary widely depending on the distribution, the particular product and the relevant jurisdiction or jurisdictions. Product providers also seek to document the respective roles and responsibilities.
 8. Article 3(2) of the Prospectus Directive has resulted in product providers having a legitimate basis for concern as to compliance by distributors with selling laws. Pending clarification of the meaning of the Directive in this respect and harmonisation of national treatments, providers and distributors must co-operate closely in addressing these concerns.
 9. Distributors should also evaluate product providers counterparties ("know your product provider"), particularly as regards the product provider's performance with respect to those items mentioned in 6 above.

Interaction with MiFID and the UCITS Directive

20. The question also arises whether the approach taken in the FSA's comments on the responsibilities of providers in DP 06/4 is super-equivalent to the requirements of European legislation. The relevant European measures are MiFID³ and the UCITS Directive⁴. The imposition of super-equivalent regulation is contrary to government⁵ and FSA⁶ policy alike.

Interaction with MiFID

21. Art 4 of the MiFID implementing directive provides that member states may not retain or impose requirements additional to those in the directive except in exceptional cases where such requirements are objectively justified and proportionate so as to address specific risks to investor protection or to market integrity that are not fully addressed by the directive. In addition, this is only permitted where either the risks concerned are of specific relevance to

³ Dir. 2004/39/EC.

⁴ Dir 1985/611/EEC.

⁵ The Davidson Review of Implementation of EU Legislation (http://www.cabinetoffice.gov.uk/REGULATION/reviewing_regulation/davidson_review/) had the aim of ensuring that EU legislation has not been implemented in the UK in a way that results in unnecessary regulatory burdens. Its website comments "over-implementing or 'gold-plating' EU directives. This is when implementation goes beyond the minimum necessary to comply with a directive. It is government policy not to gold-plate directives unless there are exceptional circumstances, justified by a cost benefit analysis and consultation with stakeholders." (http://www.cabinetoffice.gov.uk/regulation/ria/ria_guidance/european_implementation_legislation.asp)

⁶ In the FSA's Better Regulation Action Plan (December 2005, www.fsa.gov.uk/pubs/other/better_regulation.pdf), John Tiner states in the Foreword that the FSA will not gold plate. "There are also significant practical and legal constraints on how far we can go towards a more principles-based approach, such as the need to meet EU obligations. We reaffirm our commitment to implementing directives in a sensible and proportionate way. We must implement the minimum requirements, even if they would fail a cost-benefit analysis from the viewpoint of the UK. But we will not gold-plate EU requirements. We will only add additional requirements when these are justified in their own right." ³. See also ⁶: "Our basic approach is to 'copy out' the text in our Handbook, adding interpretive guidance where that will be helpful. This avoids placing unintended additional obligations on firms. We will not gold-plate EU requirements. We will only add additional requirements when these are justified in their own right."

that member state, or the risks concerned have only become evident after the date of application of the implementing directive.

22. There is no exact equivalent to the guidance set out in DP 06/04 in the MiFID regime. Art. 19(1) imposes duties of fair dealing,⁷ and art. 19(3) imposes disclosure requirements.⁸ These duties are owed to *clients* and, in the case of 19(3), *potential clients*.

23. The FSA argues that the Statement in Annex 1 to DP 06/04 does not impose new requirements, but "...is an articulation of what we believe the existing Principles for Business mean."⁹ We do not believe this to be an accurate characterisation. HM Treasury and the FSA have taken the general view that the Principles for Business are compatible with MiFID. In the light of its anti-gold plating policy, we assume that the FSA must therefore have taken the view that the Statement does not gold plate MiFID, possibly on the basis that it merely clarifies obligations under articles 19(1) and (3) of MiFID. However, we would question whether that is correct on the following basis.

(a) MiFID articles 19(1) and (3) relate to *clients* and *potential clients*. *Client* is defined as "any natural or legal person to whom an investment firm provides investment and/or ancillary services."¹⁰ Thus, where A provides services to B, and B provides services to C, C is not the client of A for the purposes of MiFID. On that basis, it is arguable that the Statement as it relates to the duties of derivatives providers to the customers of distributors/retail product providers, amount to gold plating since the derivatives provider generally deals with a retail product manufacturer rather than the underlying customers.

(b) Note also that these duties do not apply (broadly) in respect of trading business with clients who are eligible counterparties.¹¹ The distributors/manufacturers of retail structured products will often in practice be firms that are eligible counterparties for the derivatives provider. The carve-out for eligible counterparties does not extend to the provision of advice, but to the extent advice is being offered. The relevant duties are owed to the client and not to someone purchasing products issued by the client.¹²

⁷ "Member States shall require that, when providing investment services and/or, where appropriate, ancillary services to clients, an investment firm act honestly, fairly and professionally in accordance with the best interests of its clients..."

⁸ "Appropriate information shall be provided in a comprehensible form to clients or potential clients about:

- the investment firm and its services;
- the financial instruments and proposed investment strategies; this should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies;
- execution venues; and
- costs and associated charges

so that they are reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered and, consequently, to make investment decisions on an informed basis. This information may be provided in a standardised format."

⁹ DP 06/4, 5, para. 1.11.

¹⁰ Art. 4(1)(10).

¹¹ Art. 24(1).

¹² Investment advice is defined in art. 4(1)(4) as "the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm in respect of one or more transactions relating to financial instruments."

As indicated above, "Client" is defined as "any natural or legal person to whom an investment firm provides investment and/or ancillary services." Art 4(1)(10).

Interaction with the UCITS Directive

24. The UCITS Directive applies product regulation, principally by means of investment restrictions, and confers marketing freedoms in respect of UCITS.
25. It contains maximum harmonisation provisions broadly in the following terms. Host states may not impose any provisions within the scope of the Directive, other than those in the Directive, except in relation to capital movements, host state non-scope law and marketing requirements.¹³ Home states may only apply stricter or additional requirements within the scope of the Directive where "they are of general application and do not conflict with the provisions of this Directive."¹⁴
26. The Statement is not product specific, and in this sense may satisfy the general application test above. If so, it is arguable that as far as it could have an impact on UCITS product design – i.e. by effectively introducing restrictions on derivatives use by or availability to UCITS - it may inhibit the full exercise of the investment powers conferred by UCITS III.¹⁵ To that extent, it could involve gold plating.

Annex I – "Statement of Responsibilities of providers and distributors"

27. The first point to make in this context is that the Statement does not describe or consider the position of the vast majority of securitised retail product providers. The unvoiced assumption within the Statement is that providers will necessarily fall into one of two classes:
- those who simply sell structures without knowing how they will be used by the purchaser ("pure manufacturers"); or
 - retail-facing organisations who structure products as part of an existing retail business ("retail manufacturers").

The reality of the position as regards retail structured products is that very few providers fall into either of these categories. In most cases the development of a particular product will have been an iterative process between the provider and the distributor, with the distributor

"Investment and/or ancillary services" are defined in Art. 4(1)(2) and (3) by reference to Sections A and B respectively of Annex I. These include investment advice (A(5)) and investment research and financial analysis or other forms of general recommendation relation to transactions in financial instruments (B(5)).

It follows that there may be circumstances in which a provider engages in the provision of investment advice for the purpose of MiFID to a distributor/retail product provider which is therefore its client.

¹³ "Subject to the provisions governing capital movements and to Articles 44, 45 and 52 no Member State may apply any other provisions whatsoever in the field covered by this Directive to UCITS situated in another Member State or to the units issued by such UCITS, where they market their units within its territory." Art. 1(6).

¹⁴ "Without prejudice to paragraph 6, a Member State may apply to UCITS situated within its territory requirements which are stricter than or additional to those laid down in Article 4 *et seq.* of this Directive, provided that they are of general application and do not conflict with the provisions of this Directive." Art. 1 (7).

¹⁵ Indeed, the FSA stresses investor protection concerns relating to the full exercise of those powers as they relate to derivatives: DP 06/4, 12, paras 4.1 - 4.6.

providing input as to retail market conditions and the provider offering input as to what products can be produced and at what price. It is not correct to describe this as a situation where the distributor "designs" the product, but at the same time it is equally incorrect to describe the provider in such a situation as a "retail manufacturer", since he will have little or no knowledge of the retail market or the distribution strategy to be adopted.

28. It should also be noted in this context that the Statement implies that all distributors fit within a single type. This type appears to be that of a mere intermediary, having no significant influence on the structure of the product. In the context of securitised retail structured product distribution this is incorrect – distributors may have significant input into the structure, design and risk profile, but without having the complete control which would bring them within the class of "retail manufacturers" as illustrated in the Statement.

29. The approach which is sought in the Statement is constructive and helpful. However, because of the very high level of generality at which it is pitched, there are a number of provisions which, translated into the practical sphere, impose inaccurate or impossible burdens. For example, para 5.2. provides that where the distributor has provided a complete set of product requirements to the provider, then the distributor "...will be likely to carry some responsibility for product design", but where "a distributor ... has merely communicated what its customers would like to buy to the provider and the provider has independently designed or redesigned a product in response" then it has no such responsibility. This produces a position in which neither the distributor nor the provider are responsible for the product, since a provider cannot be responsible for distribution in circumstances where he has no knowledge of or involvement in it, but a distributor is not responsible if he has not had a hand in the detailed product design. The practical solution in this case would be that responsibility must be allocated between the distributor and the provider based on the facts of the arrangement. This could be dealt with relatively easily in the Statement by providing that the distributor and the product provider should have:

- undertaken a process by which they have collectively considered the position of the consumer;
- agreed between themselves which of them would be responsible for which aspects of the sale and after-sale care of the consumer;
- recorded the outcome of that consideration; and
- ensured that the consumer received information on this, that enables them to identify which entity to turn to in the event of any queries.

We believe that the Statement should voice a presumption that the participant who has the most significant degree of contact with the customer is the entity to whom the customer should look in this respect in the first instance, unless the customer is explicitly informed otherwise by all relevant parties.

30. In section 3 of the draft Statement there are some general observations about obligations in this context. These observations are appropriate as an introduction to what follows, but it should be made clear that they are merely introductory, and not intended to be a binding distillation of the remainder of the paper.

31. In para. 3.1 of Annex 1 the Statement summarises product providers' responsibilities under the following five headings:

1. the design and testing of products and an assessment in broad terms of their suitability for different types of customer;
2. selection of appropriate distribution channels;
3. provision of appropriate information to distributors and, where relevant customers;
4. monitoring of the end result, i.e. in broad terms, to monitor whether there is any indication that products are ending up with the right type of customer, whether the products continue to deliver what the provider promised, and acting when they do not; and
5. delivering prompt post-sale service, e.g. claims handling.

We consider each of these in turn (but stress that in 3.1 they should have been characterised as a general introduction to these issues, as distinct from any definitive wording on them or as an all-encompassing list of responsibilities).

1. Design and testing of products and assessment in broad terms of their suitability for different types of customer

32. The Statement says (at para. 4.4) that:

"When undertaking product design, the provider should identify the target market, namely which types of customer the product is likely to be suitable for. Depending on the nature of the product and its general risk profile, the provider may do this by identifying which types of customer the product is not suitable for – which in a given case may be just by establishing whether the product is appropriate for the mass market or not."

33. Although the Statement does not advert directly to MiFID, this concept appears to be very similar to the concept of appropriateness set out in Art. 19(5) of MiFID. The confusion between "suitability" and "appropriateness" in this excerpt highlights the extreme difficulty of distinguishing between the two¹⁶, and inadvertently emphasises the difficulty of product providers in deciding what to do.

34. As set out above, a provider (who will have a good understanding of the risk-reward relationship of financial products) will never have access to detailed market knowledge about specific customers – even where the provider has a retail bank within its group. For the reasons given above (management structure, law, regulation and customer confidentiality) it is most unlikely that information which is available to the retail-facing part of the bank will

¹⁶ Suitability is assessed by looking at the circumstances of the individual customer and determining how the economics of the product interact with those circumstances. Appropriateness, by contrast, is determined by considering the product itself and deciding what sort of customer it might be suitable or unsuitable for. This appears to be a clear distinction, but the reality appropriateness can only be assessed by creating a hypothetical customer representative of a particular class with a typical existing portfolio and risk appetite. The appropriateness assessment then becomes a suitability assessment conducted as regards that hypothetical customer.

be available (freely or at all) to the product provider part of the bank. It is therefore not at all clear how such a provider could go about classifying the product in the way suggested. As was made clear by the FSA in the Lloyds TSB Final Notice of 23 Sept 2003 (see e.g. para 2.1.5), unsuitability is a function of both the structure of a particular product and the percentage of the customer's investable assets which are invested in it. For a provider who does not have direct exposure to the retail markets, even if it is possible to quantify such amounts along Lloyds TSB lines (e.g. "investors of type X should not have more than 20% of assets in this product, and investors of type Y not more than 35%"), it is very difficult to see how this could be translated into an assessment of which customers the product is suitable for¹⁷. Interestingly, FSA cite as a possibility the idea that this exercise might be done "just by establishing whether the product is appropriate for the mass market or not" (para 4.4). It is very difficult to see how any product could be regarded as either so risky as to be unsafe for retail investors in any circumstances, or so safe as to be appropriate for any imaginable retail investor.

- 35.** The important question, of course, remains as to how the product provider should assess the customers of the distributor who, by definition, he does not know. Distributors are generally prohibited (or at least heavily restricted) by confidentiality legislation from providing this information to product providers, and it is notable that the Statement stops short of requiring them to do so. Thus, it seems that product providers must conduct appropriateness reviews based on hypotheses about the nature of the customers of the distributor. It is not clear that such assessments would have any value. Fundamentally, if the originator does not have the information to make a useful determination there seems little or no point in obliging him to make a useless one. The Statement should be recast in order to make clear that providers are only required to do this in circumstances where they have sufficient information about the distributor's customers to make the exercise of use or value.
- 36.** The Statement also addresses stress testing. The essence of the FSA's observations on this topic is that "As part of the process of identifying the risks posed by the product to the target market, the provider should consider stress-testing the product to identify how it might perform in a range of market environments and how the customer could be affected." (Para 4.6). This is uncontroversial as regards a product with which the provider is familiar, but for the reasons given above this will be the exception rather than the rule. Also the simple reference to the producer is oversimplified - there is nothing to be gained by requiring the producer to provide this information in circumstances where the distributor intends to produce it. It is helpful that the Statement confirms that there is no need to stress test products whose return is linked linearly to indices or other external factors. However, stress-testing is in effect required where a product is, for example, geared or has pay-outs which are indicated or promised in the product's description but not guaranteed.
- 37.** The issue of stress-testing also illuminates a contradiction which has been present for some time in regulatory policy which should be examined and resolved in this Statement. The FSA has for many years sought to discourage the use of "target return" or similar disclosures to investors, on the basis that investors should not be encouraged to believe that they will receive these returns when in fact they may not. This view is also held by the industry, who

¹⁷ It should be clear that the number of "typical" customer groups is capable of almost infinite subdivision and aggregation. For example, a sophisticated retail bank might have different typical customers for branches in different geographical areas – thus it may deem a product appropriate for sale in Marylebone but inappropriate for sale in Aldeburgh. However a less sophisticated distributor might class all of its retail customers under a single heading.

are concerned about misrepresentation liability. On the other hand, it is easy to see why the FSA should in this context wish to see firms give investors more information about particular possible investment outcomes. Neither the FSA nor the industry can be satisfied with this position. What is necessary is for the FSA to consider whether, and in what circumstances, it would be prepared to see firms providing potential investors with information as to potential future returns. If this is not done, the risk of regulatory censure will discourage (or, as is currently the case, stifle) the provision of such information.

- 38.** It is noteworthy in this context that the Statement suggests that stress testing should continue during the whole life of the product (para 4.7). This makes sense during the offer period, but it is hard to see what a stress test conducted by the product provider after all of the relevant products have been sold is intended to achieve unless there has been a positive and express assumption of responsibility by the product provider to the customer to keep the customer informed of the value of and risks to his investment. As noted above, in the securities business this is much more likely to be an obligation of the distributor rather than the issuer of the securities, and the regulator should not create pronouncements which disturb such arrangements. Clearly, one way in which the distributor can discharge these responsibilities is to put in place arrangements with the provider whereby the provider gives him periodic information which he can in turn pass on to his customer. However, we are concerned that the way in which the Statement is framed could be seen as giving rise to a positive obligation on the provider to do this in all cases. This would strongly contravene the FSA's expressed objectives of not requiring that a firm take on the obligations of other firms in the distribution chain (para 1.4 of the overview).

2. Selection of appropriate distribution channels

- 39.** The product provider is required to have a view on what the appropriate product distribution channels would be for a particular product. This view must be fairly sophisticated – for example, it is suggested that the product provider should decide whether the product is most appropriately distributed through IFAs, a tied sales force or through direct offer advertising, and presumably must then monitor the actual marketing process engaged in order to see whether it satisfies this requirement. Much is made in Annex 2 of the idea that the product provider should decide whether the product is such that a hypothetical investor should obtain expert advice as regards investment in it. Again, these recommendations have considerable force as applied to a "retail manufacturer" who is crafting products to meet retail demand flowing from its existing business, but do not easily apply to providers who are producing products for independent distributors. If independent distributors were to give providers generic disclosure as to the types of investors who have invested in a specific product it might be possible for a provider to engage in this process. However (a) we do not believe that distributors are generally prepared to provide this information to providers without compulsion (in many cases they will not be permitted to provide this information in any event), and (b) even if they were to be compelled to provide it, the provider would simply be repeating an exercise already done by the distributor, in respect of which he has less information, less experience and less market knowledge than the distributor. All of this seems to boil down to a requirement that the provider should second guess the distributor in the distributor's core area of expertise.
- 40.** As regards the selection of the distributor, in addition to satisfying itself that the distributor has appropriate expertise, it is also suggested that a provider should satisfy itself that the relevant distributor has appropriate systems and controls in place to manage the distribution

and after-sales service requirements in respect of the product. This is only feasible if an equivalent obligation is placed on distributors to make full disclosure of its systems, controls and business processes to the provider. The Statement does not suggest that distributors should be placed under any such obligation (and arguably a provider should be able to rely on a regulated entity to have appropriate systems and controls).

3. Provision of appropriate information to distributors and, where relevant, customers

- 41.** One of the core imperatives of the Statement is that providers should not and must not assume that because distributors are authorised firms the provider therefore owes them no duties at all. As authorised persons, providers owe duties to anyone with whom they deal to do so with due skill, care and diligence, and FSA derives from this (in para 4.13) a requirement that information must be sufficient, appropriate and comprehensible in substance and form, and that in order to meet this requirement the provider should consider what information the distributor already has, his likely level of knowledge and understanding, his information needs and what form or medium of communication will best meet those needs. This is questionable, since it ignores the most important aspect of this relationship, namely that it is only the distributor who can know whether he himself understands the product or not. It is surprising that this part of the Statement does not place more emphasis on the distributor's obligation to communicate clearly and in good time to the originator whether or not he understands the product. This can perhaps be put as the mirror image of the proposition articulated above – the distributor should not and must not assume that because the originator is an authorised firm that the distributor therefore owes the originator no duties at all. Given that the distributor is the only person who knows the make-up, identity and level of sophistication of the customers, it is necessarily he who is primarily responsible for the information flow between originator and customer. He therefore has an obligation to the originator to make as clear as he can what information those consumers need, and to ensure that he himself has received and passed on that information in an appropriate fashion.
- 42.** It is hard to understand why the Statement asserts that a distributor should only "consider" not distributing a product if he is satisfied that he does not understand it. It seems to us that a distributor is under an obligation not to distribute a product which he does not feel that he understands sufficiently, and that this obligation should be robustly asserted in the Statement.
- 43.** Where a product provider has responsibility for the publication of financial promotions in respect of the product, he is of course required to ensure that the promotion is fair and not misleading. The Statement also suggests that the publisher of the promotion has a responsibility to consider the target market, including its likely level of financial capability. It is also suggested (at para. 4.10) that even where the distributor is responsible for the promotion, the provider should consider what information the customer needs to understand the product, its purpose and the risks. The "likely level of financial capability of the target market" should be restricted in scope to the likely level of financial capability of the retail market in general in a given jurisdiction, as providers have no knowledge about the financial capability of the specific potential investors whom the distributor targets.
- 44.** Finally, there is an observation that the provider should consider communicating to the customer in advance of the occurrence of significant events in relation to the product (such as contractual breakpoints) that the customer "cannot reasonably be expected to recall". The

imposition of such an obligation would cut across existing contractual agreements, would need to be crafted to reflect secrecy obligations of distributors, and would be particularly problematic in the context of cross-border sales. There would also be issues as to how the costs of administering such a service could be passed on to the consumer, who presumably does not require it. It is also highly unclear how a product provider could know this without information as to the detailed customer breakdown to whom the products have been sold and the mechanisms by which they have been sold. To take a simple example, where a product has been acquired by a distributor for a client in circumstances where the distributor or a third party acts as discretionary manager, it is perfectly reasonable for a provider to take the view that the discretionary manager will recall the incidence of contractual breakpoints. Where the sale has been on an execution-only basis, the customer has no recourse to such a service and may well require reminding. However, for the provider to be able to make this distinction it will be necessary for him to know which of the two bases of sale was employed. He will not be able to determine this by examination of his own records, since in each case these will simply disclose the identity of the customer.

4. Monitoring of the distribution process - i.e. whether there is any indication that products are ending up with the right type of customer, whether the products continue to deliver what the provider promised, and acting when they do not

- 45.** The Statement says that a provider should keep "the quality of its distribution under review at a strategic, high level. This could include consideration of sales volume in relation to the expected size of the target market". The significance of sales volume is picked up in the example of SRP distribution given in part 5 of Annex 2 to the Statement, which provides that "Higher than expected volumes could indicate that a chosen distribution channel may be mis-selling." This picks up a theme from the Lloyds TSB Final Notice of 23 Sept 2003, in which the FSA successfully argued that Lloyds should have been alerted to mis-selling by unnaturally high distribution levels through its own branches. However, it should be noted that, whilst providers can monitor sales volume as a possible indicator of whether distributors are mis-selling products, the distributor alone knows the identity of the end-customers and is the sole judge of whether the products are ending up with the right type of customer and continue to deliver what the provider promised. The originator is not in a position to second-guess the distributor in these issues.
- 46.** It is also suggested that a provider should be aware "of whether a distribution channel is no longer appropriate to the product being sold" as a result of changes in the market or of the risk profile of the product relative to the market or to other available products. This seems to require providers to maintain a sophisticated knowledge not only of their own products and their marketing but also of the products of other providers (and of other competing products such as life policies and fund units). This is an unrealistic requirement for any provider. A provider is, of course, a market expert as regards the market for his own products, and providers will normally have a sophisticated understanding of the needs, priorities and requirements of the distributor-clients with whom they have a business relationship. However a provider will not typically be able to second-guess the retail markets in which the distributors operate. Consequently, it is not easy to see how a provider can police which particular channels are being or should be used.

47. It is also suggested that the provider should regularly review the products which he has created to check whether the product is continuing to meet the needs of the target audience, and to see whether the product's performance is likely to be materially different from any expectation conveyed to the customer (or the distributor) at the time of sale. The Statement says that "If this occurs in a way that will have material negative impact, the provider should consider whether and how to inform the customer of this (to the extent the customer could not reasonably have been aware) and of their option to seek advice.". As with stress testing, the onus to monitor a product's performance should only be on a provider during the offer period rather than throughout the life of a product. It is for the distributor to monitor product performance during the life of the product and to relay the information to end-customers as the distributor alone has contact with the individual customers and knows their requirements and expectations and can monitor whether a product is performing as expected. If the distributor requires the assistance of the product originator to this end, it is for the distributor and the originator to agree amongst themselves how this can best be delivered.

5. Delivering prompt post-sale service

48. The information which needs to be provided to the customer post-sale may include information as to the current value and possibly the expected redemption value of the product.¹⁸ Retail structured products may, however, raise particular issues, related to the fact that by design they provide investors with a payout that is quite distinct from that of traditional securities and will often be intended to be held to maturity. This means that customer expectations – as to the nature of any post-sale information, as much as the specifics of any one piece of information – may require particular attention. As with other aspects of the interface with the customer, this requires the sort of knowledge as to the investor's understanding which the distributor is clearly in the best (and generally the only) position to assess. To the extent that the distributor may need to seek post-sale information from the provider who is a participant in the wholesale markets, the framework for that interchange should be subject to the same careful attention as the other aspects of their relationship. The relative roles, however, should remain consistent with those other aspects of that relationship, and should not therefore entail inappropriate direct contact between provider and customer.

Annex II – "Some illustrations of the responsibilities of providers and distributors"

49. The source of the difficulties identified above comes into sharper focus when we turn to the examples. Arguably, there is no single model of retail distribution relationships which is universally applicable to all cases and all circumstances. Accordingly, we do not believe any detailed proposals could be created in such a way as to be both sufficiently specific to provide guidance on individual relationships and sufficiently general as to be universally applicable across this entire product universe.

50. The reason for this is that there is a strong structural distinction between the traditional retail products markets (notably the life assurance markets) and the securities markets. In the

¹⁸ See, for instance, Counterparty Risk Management Policy Group (July 2005), Executive Summary, paragraph 41e: "the secondary market value of the product at or near issuance will be less than the issue price as a result of embedded pricing factors that reflect anticipated costs and revenues to the selling institutions".

traditional financial products markets it is the life company, fund management house, bank or other institution which develops the market, creates and advertises products and manages customer relationships, to the extent that distributors are frequently little more than introducers. In the securities markets by contrast the customer is primarily a customer of the broker, private bank or other advisor, and looks to that person for continuing support and information about the products which he has bought. The structured product market is still broadly a securities market, and therefore adopts the securities paradigm, in that the primary relationship is between the customer and the distributor, with the provider doing little more than providing information. However, this paradigm is not included in the list of examples considered and, as a result, the examples are less useful than they could be in understanding that market.

- 51.** As regards the sub-prime mortgage example, this is a case where the product provider is subject to detailed requirements as to his conduct under MCOB. It may be noted in passing that this immediately marks the transaction out as one where, under the existing regime, the provider has substantial regulatory obligations to the borrower, but that these obligations are specific to the type of transaction concerned.
- 52.** The general insurance example is, likewise, hard to extrapolate from. The provider is clearly required to comply with the terms of ICOB 3 as regards financial promotion and ICOB 6 and 7 as regards dealing with specific aspect of the policy (early cancellation, claims handling), but again it is not possible to identify any specific obligation that is owed over and above these requirements.
- 53.** The pension example is a case where the distributor needs to know little or nothing about the product. Both the provider and the distributor rely on the fact that the product is a stakeholder product to establish suitability, and the product selection is made almost exclusively on the basis of charges (para 3.5). In these circumstances practically the entirety of the obligation of dealing with the investor is therefore placed (appropriately) on the provider.
- 54.** The UCITS III example, however, appears more relevant (from the point of view of those in the RSP market). The point is made that advertising addressed to financial advisers must be prepared for, and comprehensible to them. It is suggested that the provider should stress test the product against various scenarios, and we assume (although it is not explicit) that the information derived from this testing should be provided to distributors (at para 4.21).
- 55.** One of the more difficult things about this example, however, is the observation (at para 4.28) that the provider should have regard to the adviser's information needs and level of knowledge and understanding. Clearly if an adviser asks for assistance in understanding the product that assistance should be given. The problem for providers in practice, however, is how to determine the adviser's level of understanding, expertise and knowledge. Clearly if an adviser expresses himself to be in need of further explanations or information, the provider should provide these. However, the difficulty arises where the adviser expresses himself to be satisfied with the information which he already has. The question here is one as to whether and to what extent the provider can rely on this "self-certification". This is one of the more significant problems facing providers in the current market, and it would be helpful to take the opportunity to address it. Broadly, an obligation needs to be placed on distributors and advisers to seek from providers any information they may need on a product.

56. Finally, it would be inappropriate to leave this example without pointing out a further incidence of the false link between product complexity and investor understanding. What investors need to understand is the likelihood of particular investment returns and their exposure to risks. In the retail structured product markets product complexity is often the result of products being structured to create more tailored – and quite possibly less risky – investment outcomes.
57. The capital-protected retail structured product example is based on the concept of a retail-facing institution creating a product based on its own knowledge of the retail business for distribution through its own branches (and also through IFAs). The object of the example is clearly (at least in part) to illustrate that the wholesale market counterparties selling products to the retail bank are not affected by duties to the ultimate customer, and this is a helpful and a welcome clarification. However, the facts of the example do not, in broad terms, touch on the issues faced by providers generally, and are therefore not really relevant to the issues faced by retail structured product providers or distributors.
58. Again the focus on complexity is unfortunate, in that at para 5.13 it is suggested that customers should be segmented according to their knowledge of structured products rather than exclusively by reference to their investment objectives and risk tolerance. The suitability of a particular product for a particular investor is a function of the investor's existing position, investment objectives, risk tolerance and financial needs. The complexity or otherwise of a product is not a relevant characteristic in the making of this determination – what matters is whether the investor understands what the risks are and what the returns are likely to be. We suspect that this proposition may be the result of confusing "complex" and "high risk". Many structured products are structured specifically to provide the investor with protection – that is, the investor gives up some part of his potential return in order to increase the predictability of his final return. Products of this kind are optimised for investors with lower risk tolerances, and are likely to be unsuitable for investors who are actively seeking higher levels of risk.

Question 2: Do you consider that firms are already acting in line with the obligations referred to in this Statement?

59. For the reasons set out above, we do not believe that the Statement as currently drafted properly addresses the specific issues which arise in the context of the distribution of structured products in securitised form. Consequently, it is not possible to respond to this question at this time.

Question 3: Where a firm is not yet meeting the obligations referred to in the Statement, what is the likely cost to the firm of bringing their activities into line?

60. For the reason set out in the response to the previous question, it is not possible to respond to this question at this stage.

Question 4: Do you agree that we are the right body to publish this Statement?

- 61.** The simplest response to this question would be to say that because the Statement purports to be a reflection of general practice, accompanied by some examples of to how that practice might be manifested in the context of particular transactions, and does not comprise binding rules or guidance, it is not relevant who publishes it. Strictly speaking, the FSA does not have statutory authority to give binding determinations as to the interpretation of the principles, and this is ultimately a matter for the tribunal and the courts. However, it is clear as a practical matter that the fact that the Statement is published by the FSA may give it more force across the industry as a whole than would be the case were it published by a trade association or similar body.
- 62.** As set out above, industry participants and industry bodies have been working together for some time, and are in the process of developing between themselves a set of norms intended to capture and illustrate practice in the industry. This clearly illustrates the desire for a slightly more visible consensus to be achieved in this area. To the extent that it is possible to identify, elaborate and illuminate this consensus, it is helpful for the FSA to be aware of its development and to be publicly supportive. To the extent that FSA publication of an appropriate statement constitutes endorsement by the FSA of industry general practice, this is an outcome which would be welcomed.
- 63.** There is, however, an issue regarding the extent to which the FSA is optimally placed to determine and publicly promulgate this consensus view. The danger which is posed by the FSA's publicly asserting authorship of the Statement is that it may come to be perceived as a contribution to the debate by the FSA rather than as a statement of practice.
- 64.** In this respect, we are of course aware that TCF is a very large subject which covers a multitude of different products, industries and distribution models. Securitised retail structured products are merely one aspect of this market, albeit an important and fast-growing one. One possible outcome of this process might therefore be a statement produced in respect of securitised retail structured products (including, for this purpose, some structured UCITS products). But it would be helpful if the process allowed for the possibility of industry guidance developing, to build on any Statement of principles ultimately published by FSA.