FSA

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Consultation title	**Retail Product Development and Governance – Structured Product Review**
Date of consultation	2nd November 2011 to 11th January 2012
Summary of feedback received and our response	*Introduction* In November 2011, we published a Guidance Consultation on the development and governance of retail structured products. As we noted in the Guidance Consultation, consumers have responded to the volatility of many asset classes by seeking security, but are constrained by very low or negative real yields on traditional savings and investment products. This has led consumers to be attracted by products that claim to offer a degree of security but which promise returns that outperform cash. Firms have responded by manufacturing and marketing products that aim to deliver better-than-cash returns. In many cases, both the benefits and the risks of these products are opaque. We were concerned that the continuing growth in the market for structured products generally (including structured deposits), together with increasing product complexity, would place strain on firms' product governance. Lack of robustness in firms' product development and marketing processes would increase the risk of poorly designed products and mis-selling or mis-buying further down the value chain. So we carried out a review in structured product provider firms between November 2010 and May 2011 to assess the extent of these risks, and how they might be mitigated. In the November 2011 publication, as well as reporting on that review, we also consulted on new guidance which set out our expectations about product development and how firms bring to market retail structured products. Our previous work, including our investigation of the structured investment products market following the Lehmans collapse in 2008, had identified *potential* risks to consumers arising from several factors, and we set out material on these issues in our communication of October 2009, *Treating Customers Fairly – Structured Investment Products*.

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	For structured investment products, the November 2011 publication built on the October 2009 communication, which was itself based on *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers* (the RPPD) guidance. The November 2011 publication made tailored comments on the way that the RPPD (and the relevant Principles to which it relates) should be interpreted by structured investment product providers. For structured deposits, the publication proposed new formal guidance on the Principles, and on certain BCOBS rules. Overall, the publication proposed guidance on: • Principles for Businesses 2, 3, 6, 7, 8 • SYSC 3.1.1R / 4.1.1R, SYSC 8.1.6R • COBS 4.2.1R, COBS 4.4.1R, COBS 4.5.2R • BCOBS 2.2.1R, BCOBS 2.3.1R, BCOBS 4.1.1R • The Prospectus Rules The publication also contained (at Annex 2) some guidance on the Unfair Terms in Consumer Contracts Regulations. As this is not guidance on our Handbook, and so not subject to consultation, it became made guidance when we published it. While the November 2011 publication proposed guidance for provider firms on the development of structured products, it might also be relevant to other retail products with appropriate modifications.
	The consultation The consultation period for this proposed guidance closed on 11 January 2012. Our specific questions were: 1. Do you agree with the proposed guidance for: a. business models? b. product approval procedures? c. identification of target markets and idea generation? d. design and development of product features? e. stress-testing and modelling, both in the text and in Annex 1? f. selection and monitoring of distribution channels? g. information to distributors? h. information to consumers? i. post-sales responsibility?

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	2. Do you agree with our cost estimates in Annex 3 in respect of the proposed guidance? 3. Do you have any comments on the material relating to the Prospectus Rules in Annex 4? We received a total of 20 responses, including one from a body that represented several firms. The responses were broadly supportive, but did raise a number of issues, mostly queries and points for clarification. We set out a summary of those issues, together with our responses below.
Issues raised	**Our response**
General comments	
Provider/distributor boundary • There are limits to product provider responsibilities towards end customers, particularly where advice to invest is provided by an intermediary.	Our publication builds on *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers* (the RPPD), and sets out clear guidance tailored to providers involved in bringing retail structured products to market. As such, our guidance does not intend to address advisers' responsibilities to end customers. We draw firms' attention to paragraphs 1.15 and 1.16 of the RPPD where we talk about the labels 'provider' and 'distributor' and what a firm should take into account in considering which responsibilities apply to it under the Principles.
Europe/level playing field • There is a risk that following the guidance may mean UK providers are at a competitive disadvantage compared to those based outside UK. • Regimes should be consistent across the EEA, and current UK measures should not be superseded by later European initiatives.	The guidance largely builds on expectations which have already been set out in the RPPD, on the basis of relevant Principles. Where firms are already complying with our Principles having regard to the RPPD, the guidance should not significantly alter the firms' competitiveness We also refer firms to our comments at paragraph 1.19 of FS 11/03 (the Feedback Statement to our Discussion Paper on Product Intervention) where we note that we are aware of these issues and will take them into account as we develop our approach to product intervention. We are closely involved in a range of EU projects and are seeking any necessary changes to relevant directives and the development of an appropriate product intervention approach at the European Supervisory Authorities.

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Territorial application • How does the guidance relate to a firm producing products in the UK for distribution in another country?	As with the RPPD, where there is a non-U.K. element to the supply chain, the guidance would only apply to the extent that the Principles themselves, and the other rules referred to, apply.
Scope • MiFID and PD exemptions: is it possible to provide further clarification as to whether the FSA is proposing to apply the proposed guidance to the class of retail client defined in MiFID or to retail/public offers as set out in the Prospectus Directive (the PD)? • Some respondents proposed that the interpretation of 'retail' in the guidance should refer to a retail/public offer and thus allow exemptions based on the PD, and that the scope of the proposed guidance be limited to retail consumers only.	Our guidance, in line with paragraph 1.7 of RPPD, is intended to be relevant to regulated firms involved in the provision of structured products to retail customers. 'Retail customer' is defined in the FSA Handbook glossary as '(in accordance with the meaning of 'consumer' in article 2(d) of the Distance Marketing Directive) an individual who is acting for purposes which are outside his trade, business or profession'. The guidance simply reminds relevant firms to consider the PD. Not every firm to which the guidance applies will be affected by the prospectus requirements. Whether a person is offering securities and needs to produce a prospectus will depend on the PD tests, not on the content of this guidance. Where a firm – in bringing a structured product to market – is offering securities, then it will need to consider whether there is a public offer for the purposes of the PD.
• Discretionary asset management: the proposed guidance should not extend to the situation in which a product provider designs / develops a structured product for an institution that acts in the capacity of a discretionary asset manager i.e. where there is no on-sale of the product.	We have said in paragraph 2.3 of the Guidance Consultation that we are consulting on new guidance which sets out clear expectations about product development and how firms bring to market retail structured products. So we believe the guidance is clear in applying whenever individual retail customers are exposed to risk from structured products**.** In this regard, the guidance does apply to providers who design or develop structured products for discretionary managers selecting structured products for a client discretionary portfolio, to the extent that the provider is responsible for activities to which our guidance relates. For example: • if the provider, in designing or developing structured products for a discretionary asset manager, does not produce marketing literature for retail customer consumption, then the guidance on 'Information to consumers' will not apply;

	• when undertaking product design, the provider should for example, identify the target market which the product is likely to be suitable for (see the guidance at paragraph 7.10 – 7.13); • when providing information to distributors (as defined in the RPPD), the provider should communicate information in sufficient detail to help the discretionary asset manager understand the product and its intended target market (see the guidance at paragraph 11.7).
Business models, and Product approval procedures	
Variety of business models and role • There needs to be a clearer distinction between: o product providers; o 'component providers'; o where creation of product is driven by distributor ('reverse enquiry'); and o where a firm is acting solely as issuer/deposit taker, and so is not the manufacturer. *Allocation of roles* • The FSA should ensure that the method of origination is reflected in the allocation of regulatory responsibility for product design, development and sales approval processes. In many cases it is the distributor or overall product manufacturer which will need to carry out the lengthier product approval process and business models analysis and not the 'pure' manufacturer or 'counterparty'.	We draw firms' attention on both these points to paragraphs 1.15 and 1.16 of the RPPD, where we said that we consider the labels 'provider' and 'distributor' useful for the purposes of the RPPD. But we recognise that responsibilities flow from the actual roles or functions undertaken in a transaction, and firms should take this into account in considering their responsibilities under the Principles. In considering which responsibilities apply to it, a firm should consider the functions and roles that it undertakes in the product lifecycle.

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Identification of target markets and idea generation	
Suitability – roles/responsibility of the adviser • There should be clarification that there is no intention to impose 'real time' suitability/appropriateness' obligations on product providers, i.e. that providers must check up on the ongoing suitability or appropriateness of a product, which has predefined outcomes that were originally assessed as 'suitable'.	Our guidance is not intended to address point-of-sale suitability / appropriateness, and is not imposing any new obligation on providers to ensure a product remains generically suitable for a target investor post-sale. Our guidance in relation to 'Post-sales responsibilities' of providers builds on the guidance we have already set out in RPPD. We refer firms to paragraph 1.21 of the RPPD.
Consumer research • One respondent suggested that consumer research does not necessarily provide firms with comfort that fair consumer outcomes will be achieved.	Our reference to consumer research at paragraph 7.4 was as 'good practice'. To that extent, we believe that it may help prevent problems occurring later in the product lifecycle, even if it might not be enough on its own to ensure good outcomes.
Structured products as part of a portfolio • One comment was that investors need to have a balanced portfolio and structured products can assist investors in taking specific positions or market views.	This is a question of sales and advice standards, which did not form part of this Guidance Consultation.
Design and development of product features	
Distribution of returns • Some responses called for further clarification on what is a 'fair distribution' of returns.	We refer firms generally to Principle 6 (treating customers fairly). We do not propose to offer detailed guidance on this point. This is a matter for firms to address for themselves, taking into account the individual circumstances of their product offering.

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Firm's own balance sheet • Some said that, in paragraph 8.12, it should be made clear that firms are not prevented from selecting instruments that may also deliver an incidental benefit to the firm.	As in paragraph 5.11, we recognise that firms must operate on a commercially sound basis. Since this is already acknowledged, we have no plans to update the guidance on this point.
Complexity and risk • A number of respondents said that the complexity of a structured product does not necessarily equate to, or directly correlate with, its riskiness.	We do not equate complexity with riskiness; we say rather that the more complex a product's structure and features, the more difficult it is likely to be to explain in a financial promotion without risk of consumer misunderstanding (paragraph 12.8)
Market risk and inherent risk We were asked to provide clarification that delivering fair outcomes includes the possibility that a product may not perform as expected, provided that the risks have been appropriately disclosed.	In paragraph 12.9 of the guidance, we say that firms should promote the features of their products in a fair and balanced way, including giving a balanced impression of the prospects for achieving maximum returns. This does not mean that risk disclosure of itself can replace firms' post-sales responsibilities to treat customers fairly. We have separately set out our expectations in relation to firms' post sales responsibilities in paragraphs 13.6 to 13.14 of our guidance.
Stress-testing and modelling	
Forward-looking modelling • We should give more thought to the relative importance of back-testing and forward-looking modelling. • How possible it is to assess (future) probabilities – the validity of the assumptions built into the assessment?	We say clearly (A1.1) stress-tests should be forward-looking as well as back-testing, given the limited value of past performance. We do not expect firms to know exactly what will happen in the future but we are aware that forward-looking assessments (modelling and simulations) are currently used by firms to construct structured products. We say (in A1.5) that stress-test assumption sets incorporating correlations between market variables, together with broader economic assumptions, may be useful in establishing a policy framework for simulations. We also consider that these assumptions should be reasonable, and based on publicly-available data. We have amended the guidance at A1.5 to include this point.

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Comparison with cash • We need to give more explanation of our expectations on the comparison of a product with cash.	We do not expect a cash comparison test to be carried out but say that, if one is done, (A1.3) there should be a sufficiently demanding hurdle rate.
Principal-protected products • To what extent can firms stress-test and model principal-protected products?	Firms should note our guidance at paragraph 8.11 on due diligence on the counterparty. In addition, we say in paragraph 9.9 of our guidance that firms should ensure that they model outcomes in the case of a product performing within its design parameters, and in the case of possible failure of a design feature. In this regard, they may also need to assess the quality of any collateral underpinning the protection of capital in line with our guidance in A1.6; and they can model (carry out simulations) in line with our guidance in A1.5, to understand the expected profitability of the product from the investor's point of view i.e. the returns over and above capital invested.
Selection and monitoring of distribution channels	
Target markets • Some respondents said that an analysis of a generic target market coupled with a rigorous Know Your Distributor process, reflecting the nature and sophistication of distributors, provides a key element of investor protection. They thought this should be reflected in the guidance.	We have set out our guidance in relation to firms' identification of target markets at paragraphs 7.10 to 7.13 of our publication. A rigorous Know Your Distributor process does not replace the process described in the guidance. We have separately set out our guidance in relation to 'Selection and monitoring of distribution channels' at paragraphs 10.4 to 10.9 of our publication.

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Willingness of distributors to co-operate/provide information Respondents noted that distributors are also unwilling to supply information to providers that they regard as commercially sensitive.	We set out in paragraph 10.7 that provider firms should carry out initial due diligence on distributors, including an assessment of any risks posed to the fulfilment of the provider's legal and regulatory responsibilities. If a distributor is unwilling to supply information to a provider when it is carrying out due diligence on the distributor, we believe this is likely to impact on the provider's assessment of the risk which that distributor poses to the fulfilment of its legal and regulatory responsibilities. We also set out in paragraph 10.7 that firms should carry out continuing due diligence on distributors, including monitoring whether the products are reaching their target market. We further set out at paragraph 13.10 (under 'Post-sales responsibility') that post-sales MI may indicate broader issues such as a lack of consumer understanding of the product or problems in the distribution channel used. Where firms identify a problem with a distribution channel used, they should consider what action to take (see paragraph 1.21 of RPPD). This could include for example, the firm ceasing to sell the product through that distributor.
Non-advised distribution/BCOBS • One respondent asked us to confirm the assumption that our use of the term 'non-advised distribution' could mean the sale of structured deposits under BCOBS rules and/or it could refer to sales of structured products via execution-only channels with the use of appropriateness tests	A non-advised sale is one where there is no regulated activity of 'advising on investments' as defined in article 53 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001. For deposits, we can confirm that an authorised deposit-taker is not obliged to make personal recommendations to customers relating to particular accounts or deposit-taking services. (http://www.fsa.gov.uk/doing/regulated/banking/bcobs/q_a) For structured investment products, we remind firms that derivatives and products that embed a derivative are complex and as such should not generally be sold as execution only. Under our existing rules, they may only be sold on a non-advised basis with an appropriateness test in many circumstances.

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Information to distributors	
Appointed representatives • Some respondents argued that the information needed for distributors varies depending whether they are directly authorised, independent or appointed representatives of a provider firm.	We do not agree that different types of distributor need different information. Our guidance on 'Information to distributors' is relevant to all types of distributor.
Information to customers	
Respondents' comments here effectively overlap with those on the selection and monitoring of distributors; otherwise, COBS 4 and BCOBS 2 are existing rules, and we do not believe that 'fair, clear and not misleading' requires further comment here)	
Post-sales responsibility	
Continuing suitability of the product • Some responses expressed a concern that the FSA proposes that providers bear a duty to ensure a product remains generically suitable for a target investor.	Our guidance is not imposing any new obligation on providers to ensure a product remains generically suitable for a target investor. Our guidance in relation to 'Post-sales responsibilities' of providers builds on the guidance we have already set out in RPPD. We refer firms to paragraph 1.21 of the RPPD. The above expectations are not the same as imposing a continuing duty on provider firms to assess suitability for individual customers.
Better ability of distributor to monitor products • Similarly, there were some concerns about the practicality for providers monitoring products: distributors are best placed to conduct post-sale reviews (where risks have been correctly disclosed).	We refer to our comments on the preceding issue. Paragraph 1.21 of the RPPD makes it clear that firms should periodically carry out post-sales reviews. We confirm that our guidance is not intended to address distributor responsibilities.

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Changes made to the guidance as a result of feedback received	We have considered the feedback we received to this guidance consultation but we have not made substantial changes to the guidance because we believe that the substantive points can generally be addressed by reference back to the guidance consultation itself, or to the RPPD; and other feedback has consisted of comments that do not go to the substance of the consultation. We have, however, clarified one point about simulations (in relation to the stress-testing of products) at Annex 1, A1.5, in the third bullet, which will now read (with additional text in bold): *Stress-test assumption sets incorporating correlations between market variables, together with broader economic assumptions, may be useful in establishing such a policy framework.* ***These assumptions should be reasonable, and based on publicly-available data****. Firms should establish thresholds on the probability of stressed outcomes that are likely to be acceptable to the target audience.*

Existing/Directive responsibilities • Any responsibilities should be consistent with existing responsibilities (PD/MiFID)	In relation to the interaction between this guidance and the PD, we refer firms to our comments on scope, above. In relation to the interaction with MiFID, our guidance is not intended to address advisers' responsibilities, or replace firms' existing point-of-sale obligations under COBS.
Cost estimates	
We received seven responses to our CBA. All but one of these responses did not address specific points in the CBA. The one respondent that did questioned whether our reliance on published CBAs of existing rules and past research meant that we are using out-of-date estimates. We have made a public commitment to undertake and consult on a CBA if our proposed guidance is likely to impose significant costs that were not considered when we consulted on the rules to which the guidance relates. The actions that we identified could fall into this category included those in relation to TCF outcomes and to product stress-testing and modelling. Our estimates of these costs for the former were from research conducted in 2008 and the latter from 2011, which we do not regard as out of date.	
Prospectus Rules	
There were no substantive comments on the material on the Prospectus Rules.	

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Full text of the guidance consulted upon can be accessed here