

Guidance consultation

Retail Product Development and Governance – Structured Products Review

November 2011



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1 Executive Summary

- 1.1 Structured products¹ are rising in popularity and we are concerned that the growing number of structured product sales, as well as increasing product complexity, is placing a strain on firms' systems and controls. A lack of robustness in firms' product development and marketing processes can increase the risk of poorly designed products and lead to mis-selling, or mis-buying by consumers.
- 1.2 To address this risk, we assessed seven major providers of structured products between November 2010 and May 2011. The review specifically looked at how the firms were designing structured products, identifying their target markets, and how they handled post-sales responsibilities. Following our review, we now publish proposed guidance for consultation.

What firms should do – in outline

- identify the target audience and then design products that meet the target audience's needs, rather than merely contributing towards the firm's bottom line;
 - stress-test new products to ensure they are capable of delivering fair outcomes for the target audience;
 - ensure a robust product approval process for new products – be clear about what *is* a 'new' product; and
 - monitor the progress of a product through to the end of its life cycle.
- 1.3 Further and more detailed guidance for firms is set out in each section of this publication. This builds, where applicable, on existing high-level guidance.

¹ This publication deals with structured investment products (capital-at risk and non-capital-at-risk) and structured deposits.

We define a structured capital-at-risk product (SCARP) as in our Handbook i.e. as a product, other than a derivative, which provides an agreed level of income or growth over a specified investment period and displays the following characteristics:

- (a) the customer is exposed to a range of outcomes in respect of the return of initial capital invested;
- (b) the return of initial capital invested at the end of the investment period is linked by a pre-set formula to the performance of an index, a combination of indices, a 'basket' of selected stocks (typically from an index or indices), or other factor or combination of factors; and
- (c) if the performance in (b) is within specified limits, repayment of initial capital invested occurs but if not, the customer could lose some or all of the initial capital invested.

A non-SCARP structured investment product is one that promises to provide a minimum return of 100% of the initial capital invested so long as the issuer(s) of the financial instrument(s) underlying the product remain(s) solvent. This repayment of initial capital is not affected by the market risk factors in (b) above.

We define a structured deposit as in our Handbook i.e. as a deposit paid on terms under which any interest or premium will be paid, or is at risk, according to a formula which involves the performance of:

- (a) an index (or combination of indices) (other than money market indices);
- (b) a stock (or combination of stocks); or
- (c) a commodity (or combination of commodities).

2 Introduction

The current macroeconomic environment

- 2.1 The environmental drivers of risk remain broadly the same as those outlined in our Retail Conduct Risk Outlook 2011 (the RCRO)², although the risks of slow economic growth have increased since the RCRO was published in February 2011.
- 2.2 Many asset classes are still volatile. Consumers respond to volatility by seeking security, but are constrained by very low or negative real yields on traditional savings and investment products. This leads 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.

Intervention higher up the value chain

- 2.3 In this environment, we are consulting on new guidance which sets out clear expectations about product development and how firms bring to market retail structured products. This focus on the earlier stages of the product life-cycle, in line with the new more interventionist approach to regulation that the Financial Conduct Authority (FCA) will adopt, demonstrates that we are already seeking to identify potential consumer detriment at a far earlier stage.³ In doing this, we are continuing on the same path as the recently published joint FSA and Office of Fair Trading (OFT) document, *Payment Protection Products*.⁴
- 2.4 We have published separately a Discussion Paper and a subsequent Feedback Statement on the broader issues surrounding product intervention.⁵ In the Feedback Statement, we set out ‘Next Steps’ which include taking forward a single set of rules and guidance on product governance, for example, turning some or all of our previously published material on treating customers fairly (TCF) and the responsibilities of product providers and distributors⁶ into rules, and considering additional interventions going forward.

Product governance

- 2.5 In this paper we focus on the key issues of governance which arise in the development and marketing of structured products. By governance we mean systems and controls in relation to product design, product management and distribution strategies. Our work focused on product

² <http://www.fsa.gov.uk/pubs/other/rcro.pdf>

³ See *The Financial Conduct Authority, Approach to Regulation* (June 2011) –

http://www.fsa.gov.uk/pubs/events/fca_approach.pdf

⁴ http://www.fsa.gov.uk/pages/Library/Policy/guidance_consultations/2011/11_26.shtml

⁵ http://www.fsa.gov.uk/pubs/discussion/dp11_01.pdf and http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf

⁶ The Responsibilities of Providers and Distributors for the Fair Treatment of Customers:

<http://fsahandbook.info/FSA/html/handbook/RPPD>

providers, so we did *not* assess sales processes or the quality/suitability of individual sales, nor did we include distributors in the review. The FSA will be doing further work on these issues in 2012.

- 2.6 The key finding from our review is that, while firms had taken on board many of our messages on treating customers fairly, there were still weaknesses in product governance arrangements. Overall, firms still focused too much on their commercial position, potentially at the expense of consumer outcomes.
- 2.7 We have held individual feedback sessions with all the firms in our sample, and we are taking action with those firms where we identified problems. This includes requiring significant change to product governance arrangements where necessary.
- 2.8 It is important that firms consider the issues raised in this document, compare their product governance to the guidance set out, and address all the areas for improvement that they identify as a result.
- 2.9 While this publication proposes guidance for provider firms on the development of structured products, it may also be relevant to other retail products with appropriate modifications: most firms told us that they apply the same governance principles, and follow the same or similar procedures, for all new product types.

FSA work in this area

- 2.10 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 a number of factors, including:
- poor identification of target market;
 - lack of due diligence on counterparties;
 - inadequate testing of product features;
 - lack of due diligence on distribution channels; and
 - poor use of customer feedback and other management information.
- 2.11 We set out material on these issues in our communication of October 2009, *Treating Customers Fairly – Structured Investment Products*.⁷
- 2.12 In our view, there was a risk 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

⁷ http://www.fsa.gov.uk/pubs/other/tcf_structured.pdf

marketing processes would increase the risk of poorly-designed products and mis-selling or mis-buying further down the value chain.

- 2.13 We therefore carried out a thematic review in structured product provider firms between November 2010 and May 2011 to assess the extent of these continuing risks, and how they might be mitigated. We also wanted to assess firms' responses to our October 2009 communication, and to consider whether any regulatory action against individual firms was necessary. We visited seven major structured product providers, which we estimate provide at least 50% of structured products in the retail market by volume and value.

Next steps

- 2.14 The consultation period for this proposed guidance will end on 11 January 2012. We welcome comments on any of the matters raised in this paper but our specific questions are:
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?
 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?
- 2.15 Please send your comments by email to richard.lawes@fsa.gov.uk or in writing to:

Richard Lawes
Conduct Specialists Department
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

by 11 January 2012.

- 2.16 It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure.

- 2.17 A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

3 Other obligations

- 3.1 While the focus of this communication is on product governance and treating customers fairly, we remind firms of their other relevant obligations, which continue, and which the guidance proposed in this publication does not replace.

Collective Investment Schemes

- 3.2 Structured investment products can be set up as authorised collective investment schemes (CISs), and where they are, firms should refer to the rules and guidance in our CIS specialist sourcebook (COLL), including (but not limited to) our rules on collateral and valuations. We remind firms also of our publication *Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers*.⁸ The guidance proposed in this publication would apply in addition to these existing rules.

Prospectus Directive

- 3.3 One of the legal requirements that need to be considered when designing and marketing a structured product is the potential need to produce a prospectus. The obligation applies to defined categories of transferable securities including shares in companies, bonds, and certain options, warrants and derivatives but excluding units of open-ended collective investment schemes (which may fall under the separate regime applying to such units referred to above). An offer to the public is defined as a communication in any form giving sufficient information on the terms of the offer and the securities to be offered to enable investors to decide to purchase or subscribe for the securities. Firms should reconsider the requirement to produce a prospectus in light of the specific features of each product (and each offer thereof), as small variations could change the legal analysis. We set out more detail on this in **Annex 4**.

⁸ http://www.fsa.gov.uk/pubs/other/TCF_CIs_managers.pdf

4 Guide to this document

Findings and good/poor practice

- 4.1 We set out our findings in each area at a level of detail that does not enable individual firms to be identified. The findings include examples of poor practice, where we found it. Good practice, which exemplifies some of the points proposed as guidance (see below) and may contain elements of best practice which goes beyond that, is highlighted separately.

Guidance

- 4.2 This publication contains material, which if made following consultation, will constitute guidance issued under section 157 of the Financial Services and Markets Act 2000 (FSMA). We give our view on what the FSA's Principles for Businesses and high-level rules contained in sourcebooks within our Handbook such as SYSC⁹, COBS¹⁰ and BCOBS¹¹ (as applicable) require of firms that develop and market structured investment products and structured deposits. The guidance is forward-looking, so we do not expect firms to proactively review existing products, other than under their current arrangements.
- 4.3 We also propose guidance on the Prospectus Rules. In addition, the publication contains guidance on the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs), made with immediate effect.

Interpretation

- 4.4 The proposed guidance is marked as 'Actions for firms'. We have marked the guidance applicable to structured investment products only; applicable to structured deposits only; and that applicable to all structured products, i.e. structured investment products and structured deposits. We use 'expect' or 'should' to indicate that we think firms ought to consider a particular action to comply with a rule and to achieve a desirable outcome, not that they must follow a prescribed course of action.
- 4.5 What a firm has to do to meet the requirements of a Principle will depend on the circumstances, including the riskiness or complexity of the product, who the firm is dealing with (another firm or a customer, for example) and the financial sophistication of the target market. Firms should bear all of these factors in mind in order to interpret the requirements of the Principles in a way that is proportionate. The 'Actions for firms' described in this publication apply to the extent that the Principles (and where relevant, the high-level rules contained in SYSC, COBS and BCOBS) themselves apply.

⁹ Senior Management Arrangements, Systems and Controls

¹⁰ Conduct of Business sourcebook

¹¹ Banking Conduct of Business sourcebook

4.6 The proposed guidance is not a complete exposition of all a provider firm's responsibilities. If made following consultation, as guidance issued under FSMA, it will not be binding on those to whom FSMA and our rules apply and need not be followed in order to achieve compliance with the rules or other requirements¹². There will be no presumption that departing from it indicates a breach of a rule. However, the guidance may be relevant in an enforcement context, for example to explain the regulatory context. If a person acts in accordance with the guidance in the circumstances contemplated by it, then the FSA will not take action against that person in relation to the aspects of the rules to which the guidance relates.

i) Structured investment products

4.7 For structured investment products, this material builds on the October 2009 communication, which was itself based on the *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers* (RPPD) and made tailored comments on the way that the RPPD should be interpreted by structured investment product providers.

4.8 Like the RPPD, this publication looks particularly to the following Principles for Businesses (the Principles):

- Principle 2 (A firm must conduct its business with due skill, care and diligence);
- Principle 3 (A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems);
- Principle 6 (A firm must pay due regard to the interests of its customers and treat them fairly); and
- Principle 7 (A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading)

although all the Principles remain applicable to authorised firms at all times.

ii) Structured deposits

4.9 For structured deposits, this publication proposes new formal guidance on the Principles, the most relevant of which are set out above¹³.

¹² Other requirements may include The Consumer Protection from Unfair Trading Regulations 2008.

¹³ Accepting deposits is a regulated activity under FSMA. While advising on and arranging a deposit are not distinct regulated activities, firms may have obligations under the general law or FSA rules in relation to the distribution of structured deposits in some circumstances. One example of this is where a deposit-taker chooses to give advice about the merits of the deposit to a customer in connection with the activity of accepting a structured deposit. Another example is where an independent financial adviser gives advice on a structured deposit in the context of, or as part of, giving investment advice.

Contract terms

- 4.10 The material on contract terms at **Annex 2** is guidance on the UTCCRs. We are not required by FSMA to consult on such material. We are therefore publishing this material as guidance with immediate effect.

Organisation of material in this publication

- 4.11 In the following sections, we deal first with firms' business models in relation to structured products. We then deal with the eight key areas of product development and governance:
- product approval procedures;
 - identification of target market and generation of products ideas;
 - design and development of product features;
 - stress-testing and modelling;
 - selection and monitoring of distribution channels;
 - information to distributors;
 - information to consumers; and
 - post-sales responsibility.
- 4.12 In each of these sections, we report the findings from our thematic review, outline any examples of good practice, and set out some proposed guidance under the heading 'Actions for firms'.
- 4.13 We have included annexes on:
- the technical aspects of stress-testing products;
 - contract terms for structured products;
 - our cost benefit analysis;
 - the Prospectus Rules; and
 - the rules to which our proposed guidance relates.

5 Business models

The UK market

*We are grateful to Structured Retail Products Ltd. for permission to use information from their publication *The United Kingdom Structured Retail Product Market, 2011 Review (April 2011)*.*

- 5.1 Structured products have been available to retail consumers in the UK since the early 1990s and the UK market is now the fifth largest in Europe by sales and by outstanding value. Sales fell 8% to £13.5bn in 2010 (following a 71% increase in 2009) but assets under management still rose 13% year on year to £51.96bn at year-end 2010. Respondents to a survey by www.StructuredRetailProducts.com of the main UK players in January 2011 provided the consensus view that sales would grow 15% in 2011.
- 5.2 The UK is an active market: for example, 1,006 tranche¹⁴ products were offered in 2010, the same number as in 2008, but down slightly on 2009's total of 1,096. The majority of products continue to offer *at least* 100% capital protection. However, in 2010 there were, for the first time, more capital-at-risk products available than those that offered *simple* 100% capital protection.
- 5.3 Against the continuing popularity of more simple pay-offs, there was a significant increase in the use of the auto-callable (knockout) feature¹⁵ in 2010, with 188 products, up from 123 in 2009. While the dominant underlying pay-off reference is still the UK FTSE100, diversification was apparent in 2010, especially as the year progressed. The FTSE was the sole underlying reference for approximately 90% of products in the first few months of 2010, but by December that had fallen to 65%.
- 5.4 The UK uses a wider range of financial instruments than other European markets. In 2010, the medium-term note and deposit were used most frequently, but a variety of other instruments were used, including preference shares, shares in OEICS and Special Purpose Vehicles, and certificates.
- 5.5 While there were 64 individual providers (44 provider groups) involved in the tranche market in 2010, market share remains concentrated among five provider groups, which accounted for 72% of the market in 2010.

Findings

- 5.6 Against this environment, we selected firms with different business models, using various distribution strategies. Most of the firms manufactured structured deposits as well as structured investment products.

¹⁴ A tranche product is one which is issued in successive amounts of a limited size.

¹⁵ A product with this feature matures early if the underlying index reaches a pre-defined level, either before or (usually) on a pre-determined date.

- 5.7 We found that, broadly, firms lacked a clear strategic purpose in manufacturing structured products, or at least were unable to articulate a coherent strategy. We believe this fed through into their product ranges, which we felt were disproportionately influenced by pricing and market pressures.
- 5.8 At the governance level, we found a basic weakness in firms' identification of the target market(s) for their products. We believe this reflects a strategic failure to consider: 'What do consumers need and want? How can we make it?' as opposed to 'What can we make? How can we persuade consumers to buy it?'
- 5.9 We believe it also reflects our overall finding that firms focused too much on their commercial position, potentially at the expense of consumer outcomes.

Actions for firms (relevant to all structured products)

- 5.10 All firms need to have adequate controls around the development and marketing of their products. However, where a firm's business model relies significantly on a particular product or class of product, the firm's controls over the risks associated with the development and marketing of those products should be particularly robust in order to reflect that reliance.
- 5.11 While we recognise that they must operate on a commercially sound basis, firms should strike a balance with pricing and market pressures to ensure that fair consumer outcomes are delivered.

6 Product approval procedures

Findings

- 6.1 All the firms in our sample had established a process for approving new structured products. The structure and methodology of these processes varied across firms. Processes generally ensured that new products could not be launched without obtaining formal approval and sign-off from key stakeholders.
- 6.2 Some firms had complex product governance frameworks consisting of numerous committees with overlapping memberships. We found that some key stakeholders in these firms lacked clarity on elements of the process.
- 6.3 The criteria for classifying a structured product as ‘new’ differed amongst firms, but generally related to any significant variation to the product, such as changes in: counterparties, pay-off profiles, product shape, underlying index, and distribution channels. These factors in effect determined whether a particular product or tranche underwent the full product governance and approval process.
- 6.4 A common theme was the adoption of an abridged or ‘light’ product approval process. This was typically used for approving new tranches of existing structured products. The systems and controls for the light approval processes varied significantly across firms and we identified a number of weaknesses and potential risks. Some firms had set wide parameters which could allow product features to be modified significantly without undergoing the full approval process.
- 6.5 In several cases, we observed an over-reliance on the judgement and discretion of key individuals to achieve acceptable outcomes and provide ‘sense-checks’ rather than these safeguards being embedded in the actual product approval process. By contrast, in some firms we noted that a high degree of control and influence was exerted by product design staff.
- 6.6 We also found problems with firms’ adherence to their own procedures, often under the impact of commercial pressures. Some firms in the sample had well-documented product approval systems which appeared robust on paper. However, we noted that the full governance process was not always followed in practice. A number of firms could not provide any examples of robust challenge that had been raised from a compliance, risk or treating customers fairly perspective.

Good practice

- 6.7 One firm had a post-launch review of new products built in to the approval process. Products could be approved subject to conditions, which could include specific points to be tested in the post-launch review, for example checking any risk assumptions made in the development of the product.

6.8 Another firm had a general system of reviewing products on a regular basis, to guard against ‘product creep’, where small changes to product tranches can result over time in a whole new product which has circumvented the full approval process.

Actions for firms (relevant to all structured products)

6.9 We expect firms to have transparent and auditable product approval frameworks which:

- have clear roles and responsibilities for those operating them;
- incorporate effective scrutiny and challenge;
- embed the delivery of fair outcomes for customers;
- manage any conflicts between the firm and the customer (for example in the pricing of debt issued by the firm) properly;
- have clear criteria for when an abridged or ‘light’ process may be used and for what constitutes a ‘new’ product;
- take account of changes in the external environment; and
- have a review mechanism to prevent product ‘creep’.

6.10 Firms should ensure that the product approval process is not compromised as a result of commercial, time or funding pressures, allows for review and challenge by the risk and compliance functions, and is not compromised as a result of senior management over-ride.

6.11 Firms should review and update as appropriate the approval process on a regular basis to ensure that it remains robust and fit for purpose.

6.12 Overall, we expect firms:

- to have a product approval process that is robust and fit for purpose;
- to ensure that it is implemented properly; and
- to review the process regularly.

Product Development

7 Identification of target markets and idea generation

Findings

- 7.1 A majority of firms felt they knew their customers through other products and services they supplied to them. Other firms produced a range of products over a broad retail spectrum, but without identifying particular markets for any of them. We believe this placed disproportionate responsibility on distributors.
- 7.2 All firms carried out some form of consumer research. Overall, we found that it focused on how products could be sold more efficiently, rather than on consumers' needs and wants, and on their understanding of the product. Instead, firms used a number of other sources of ideas for their products: feedback from the sales force or intermediaries; in-house investment 'themes' (such as emerging markets, commodities, inflation etc); and competitor analysis. This again reflects the relative overweighting of commercial factors compared to ensuring fair consumer outcomes.
- 7.3 Overall, we found that firms (particularly those using an intermediated distribution model) did not have a clear enough idea of a target market and of its needs and wants – and so could not communicate this to distributors: see **Information to distributors**.

Good practice

- 7.4 Some firms had programmes of consumer research, rather than simply carrying out research ad hoc. The research that gave firms a better understanding of their target market(s) was that which sought to establish consumers' potential wants and needs, and to assess what the customer actually understood about the product (and so the potential risk of misunderstanding and a less than satisfactory customer outcome). We saw research that explored consumer understanding, attitudes, values and needs, as well as research that sought to test product literature. This worked better through a qualitative approach, where there could be in-depth exploration of responses, rather than through quantitative approaches, which used pre-determined response categories.
- 7.5 One firm had filtered out a proposal for a product that referenced a particular market index at the idea-generation stage, as it was considered to be too volatile for a mass retail target market.

Further considerations

i) Advised sales

- 7.6 While target market identification by the provider helps to ensure that the right product reaches the right customers through appropriate marketing (whichever distribution channel is chosen), we recognise that in the case of advised sales this cannot replace the assessment of the suitability of a product for an individual customer by the adviser. It remains the adviser's responsibility to make a

suitable recommendation and ensure before recommending a product that they understand the risks associated with that product. Where advisers do not understand products, they should not recommend them.

ii) Equality and diversity

- 7.7 It is important for providers to ensure they are compliant with their obligations under equality legislation when identifying target markets and designing products and product terms and conditions. Understanding the diverse needs of different groups of customers, and taking these into account when developing and marketing products will help firms ensure that they do not breach equality legislation.
- 7.8 It is also important for firms to ensure they have appropriate controls in place to avoid the risk of unlawful discrimination arising from their policies, processes and practices, including in the area of product governance.
- 7.9 To find more information on legal obligations, see the Equality and Human Rights Commission website: <http://www.equalityhumanrights.com/>.

Actions for firms (all structured products, except where marked otherwise)

- 7.10 Firms should bear in mind TCF Outcome 2:¹⁶ *Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.*
- 7.11 Firms should recognise that the identification of a target market or audience is crucial, not only for generating ideas for products, but for avoiding failures later in the value chain, whether or not an intermediated model is used – consideration of the target market should permeate all aspects of the product development and distribution, particularly for:
- identifying real consumer needs and objectives and designing product features to meet them;
 - promoting the product;
 - choosing the appropriate distribution channels;
- and generally throughout the product's life.
- 7.12 To achieve this, the types of factors provider firms should consider in their product design include:
- for structured investment products*
- risk profile
 - willingness to accept capital loss

¹⁶ <http://www.fsa.gov.uk/pages/doing/regulated/tcf/>

- ability to bear loss
- importance of possible recourse to the FSCS (or another EU guarantee scheme)
- investment objectives
 - capital growth or income
 - the product's potential role as a 'core' or more speculative holding
 - other specific types of investment objective

for all structured product types

- financial situation (for example, tax status and proximity to retirement)
- the risk/reward trade-off including the possibility of the simple return of capital with no additional reward, and of inflation risk
- ability to hold the product for the full term
- financial capability and experience of the target audience

7.13 Firms should take account of the fact that changes in the financial markets may mean that products may no longer serve a purpose for their original target market as a result. Some common indices and asset classes can change their level of volatility depending on economic cycles, which is an important factor since structured products are often five or six year products. Customer needs and wants also change, in line with economic circumstances. Firms should:

- consider all these changes as factors to influence the design of new products; and
- for 'live' products, consider what action to take in respect of existing customers – see **Post-sales responsibility**.

8 Design and development of product features

Findings

- 8.1 A key point among the features of a structured investment product is whether capital is at risk i.e. subject to market risk (as opposed to counterparty risk). One firm felt that structured deposits and capital ‘protected’¹⁷ structured investment products could be grouped together in the design process, without regard to the different legal and compensation frameworks¹⁸ applying to the two types of product, and the issue of counterparty risk. Their design process did not therefore take sufficient account of consumers’ different needs and attitudes to the preservation of capital and access to compensation arrangements.
- 8.2 Firms’ perception of what is ‘simple’ or ‘plain vanilla’ was often not that of ordinary retail consumers (as evidenced in some of the firms’ own research) but was judged by comparison with what was available on the wholesale market. We detected a continuing shift towards new legal structures and more complex pay-off profiles, without always a clear consideration of whether these were of genuine benefit to consumers. Firms are, however, considering structures that are more tax-efficient for different types of taxpayer, and are generally mindful of the issue of liquidity.
- 8.3 With structured investment products, we noted various ways of mitigating counterparty risk, such as collateralisation.¹⁹ We noted features in both investment products and structured deposits that seemed to lack transparency and increase risk, such as exotic or proprietary indices.
- 8.4 We noted varying ‘lead times’ in products, from the opening of the product to investors to the ‘strike date’ (when investor funds are committed to the deposit arrangement or financial instrument underlying the product), and varying approaches to how investors’ money is held during this time.
- 8.5 Most firms had some kind of structured product design framework i.e. an internal policy which set limits to what was and was not acceptable for meeting the firm’s ‘house’ risk and other parameters. However, we found evidence of firms offering products opportunistically, based on current market and pricing conditions.

¹⁷ i.e. 100% protection, not dependent on any particular market outcome.

¹⁸ With deposits, the deposit-taker is under an obligation to repay capital to the depositor, hence the depositor has a claim with respect to a civil liability owed to him by the deposit taker and FSCS coverage is available up to the current maximum of £85,000. With investment products, where the claimant has a claim with respect to a civil liability owed to him by the product provider, there is recourse to the FSCS up to the current maximum of £50,000.

¹⁹ Collateralisation is where additional assets are earmarked as security for the financial instrument issued by the underlying provider (the counterparty) and which is designed to return capital (on the terms defined by the product). This reduces the impact of a default by the counterparty.

Good practice

- 8.6 We are aware that some firms waived the early redemption charges that were set out in the product's terms and conditions, in cases of death or other distress, where to impose the charges would be unduly onerous.

Actions for firms (all structured products, except where marked otherwise)

- 8.7 Clearly there is complex financial engineering 'beneath the surface' in structured investment products: this is also true of many other retail products.²⁰ However, firms should ensure that product features that will be visible to the consumer are likely to be understandable to the product's target market, so that consumers can:
- see where their pay-off is designed to come from; and
 - assess the likelihood of receiving it, including the possibility of no return at all on their capital, or making a loss.
- 8.8 The design process should take account of:
- the distribution of the total gross returns of the product, split between the different stakeholders in the product and whether this distribution, including fees and charges, is fair from the customer's perspective;
 - possible recourse to the FSCS (or another EU guarantee scheme), where this is important to the target market;
 - the distribution channel (including whether advice will be given and the typical customer base of distributors); and
 - the tax implications of the product's pay-off profile.
- 8.9 Firms should take particular care where product offerings link different types of product, so that the purchase of one product (typically a deposit) is dependent on another (typically a structured product). These have different risk profiles, often different maturity dates and potentially different target markets, so it may be difficult for both distributors and consumers to understand them and in particular to assess the likely overall return.
- 8.10 Firms should recognise the inter-actions of different product characteristics (such as illiquidity, and riskiness of the underlying assets) and understand the assumptions built into the design of the product (for example, the probability of equity returns being positive over any particular period) – see also **Stress-testing and modelling**.

²⁰ For example synthetic trackers (those that replicate the performance of an index through derivative instruments, rather than through holdings of the constituents of the index).

- 8.11 *For structured investment products*, firms should carry out sufficient due diligence into the counterparty and not rely solely on the credit rating agencies when selecting the securities issuer. We expect firms to look more broadly than the credit rating, such as the rating outlook, credit default swap (CDS) spreads and other market information, as well as ‘fundamentals’ on the issuer’s balance sheet.
- 8.12 The choice of underlying indices or instruments should be driven by the identified needs of the target market and not, for example, to match against other assets or liabilities on the issuer’s or counterparty’s balance sheet.
- 8.13 Where the product lead time (time in a temporary deposit or investment pending the strike date of the destination product) is substantial, firms should ensure that customers are treated fairly, and particularly in respect of:
- compensation arrangements applying in the event of any default during that time; and
 - *for structured investment products*, the investment objectives of the destination product (so that, for example, losses cannot be incurred during the lead time, if the destination product promises 100% capital protection).
- 8.14 Product design frameworks (or firms’ internal policies on risk and other parameters) should allow for periodic challenge and updating to deal with the dynamic nature of the market.

Contract terms

- 8.15 We consider it important that firms, when drafting consumer contracts for structured products, ensure that the terms of such contracts are clear and fair and accurately reflect the features of the product, as designed. In our view, the design and development of product features stage is the most appropriate time for firms to carry out this exercise. We therefore set out at **Annex 2** some details of contract terms for firms to consider during the product design process.

9 Stress-testing and modelling

Findings

- 9.1 Firms described a variety of stress-testing procedures, including quantitative modelling (some of which incorporated ‘value for money’ tests) and ‘scenario’ assessments, which included organisational and other qualitative risks. Tests generally were forward-looking as well as back-testing.
- 9.2 It was not clear that firms’ stress tests fulfilled both the purposes of such tests, which are to model outcomes both in the case of a product’s performing within its design parameters, and in the case of possible failure of a design feature. For example, for a capital-at-risk structured investment product with ‘soft’ protection²¹, the former will include modelling outcomes where customers do actually lose money i.e. the protection barrier is breached. For a structured investment product with 100% capital protection, the latter will include modelling outcomes where the protection fails, and customers lose money despite the protection feature.
- 9.3 Value-for-money tests generally involved a comparison with cash. In some cases, though, the required additional return over cash did not seem to reflect a fair risk premium for the non-cash product. There was evidence also of comparison with competitor products.
- 9.4 Stress-testing carried out in-house by some firms seemed to relate wholly to the firm’s prudential risk management, and whether the product was a commercial proposition for the firm, rather than to consumer outcomes. Stress-testing from the firm’s perspective is not the same as stress-testing from the customer’s point of view.
- 9.5 In some cases too, stress-testing was not routinely carried out, and it was not clear how the results of tests actually fed back into the design of the particular product being tested, or into future products generally. In at least one firm, stress-testing was *ad hoc*, and it was unclear what the test parameters were, so that it was difficult to see how it could be applied consistently.
- 9.6 There were varying approaches to minimum counterparty credit ratings, and there was little evidence of other methods of assessing credit risk.

Good practice

- 9.7 One firm in our sample applied a quantitative cash comparator test to all structured deposit and investment products that were entering the product design process. The purpose of the test was to confirm that the relevant proposition was statistically likely to generate a higher return than cash. The firm told us that any product which failed this test would then be filtered out by the firm’s customer propositions team (through a sign-off procedure) on the basis that it represented poor value for money and was unlikely to be a fair deal for consumers. The firm also applied a further qualitative test to new product offerings by comparing them with fixed-term savings rates available at the time of launch, to assess whether the size of the potential return that was offered

²¹ Soft protection is where the product is designed to repay capital only if the reference index does not fall below a specified level or barrier.

was sufficient to justify the risk of a consumer receiving limited (or even zero) growth on their funds.

Actions for firms – stress-test procedures (all structured products, except where marked otherwise)

- 9.8 Firms should bear in mind TCF Outcome 5: *Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.*
- 9.9 Firms should stress-test products to establish how they would perform under a variety of conditions, and ensure that they model outcomes both in the case of a product’s performing within its design parameters, and in the case of possible failure of a design feature.
- 9.10 Firms should ensure therefore that stress tests are robust, which will require the procedure to allow for challenge (or, for example, they may be carried out independently of the product design team). Stress tests should model outcomes from the customer’s perspective and have defined parameters, so that they can be applied consistently, but there should also be a transparent procedure to allow them to be revised, to take account of current market conditions and projections.
- 9.11 Stress tests should also be built in to the product approval process, with defined triggers for when they are or are not to be applied (they may not need to be applied, for example, in very simple repetitions of a recent product).
- 9.12 ‘Scenario’ testing includes internal and qualitative risks, such as the failure of the firm’s systems or larger than expected volumes. This is a necessary part of risk management, but cannot replace quantitative assessment of external, primarily financial risks (market stresses, including interest rates; where applicable, currency risks, etc.).

Actions for firms – technical aspects of stress-tests

- 9.13 Please see **Annex 1** for some detailed technical guidance on stress-testing.

Marketing – distribution and communications

10 Selection and monitoring of distribution channels

Findings

- 10.1 We found that certain distribution strategies created very distinct risks at different parts of the design and development cycle. Firms with wholly intermediated distribution strategies had a significantly higher risk profile, with additional strain on their systems and controls. These firms accepted only limited responsibility for product distribution and relied on distributors to identify the appropriate target market, with the consequently increased risk of mis-selling.
- 10.2 Management information (MI) on the performance of distribution channels was captured by all firms in the sample. However, this varied in quality and firms often could not explain i) exactly what they were looking for; and ii) what standards they were assessing the information against. Firms tended to assess the performance of their channels through sales volumes rather than from the perspective of treating customers fairly, and the majority of firms could not articulate the circumstances under which they would cease using a particular distribution channel. There was also limited evidence of information feeding back into product design and development.

Good practice

- 10.3 A firm in our sample had planned to launch a new investment product for distribution through multiple retail sales channels. Initial due diligence indicated that the proposition itself was complex and that consumers were likely to need detailed advice to help them to understand it sufficiently. The firm accordingly restricted distribution of the product to one of its exclusive/premier channels. The customer base that was served by this channel was broadly consistent with the target market that had been identified for the product at design stage. Clients served by the channel also received longer sessions with advisers ensuring that appropriate time could be spent explaining complex features. The firm subsequently assessed post-sales MI to ensure that the product had reached the correct target market. Although sales volumes were high, adviser feedback indicated that certain features were difficult to explain to customers. Additional training was provided to the relevant sales force and certain features were removed for subsequent tranches. The product was not approved for distribution to mass retail market consumers as it was felt to be too complex and inappropriate for their needs.

Actions for firms (relevant to all structured products)

- 10.4 Firms should decide whether their structured product is one where customers would be wise to seek advice. If a structured product has complex features which are difficult to explain to customers, firms should take particular care with the use of non-advised distribution.

- 10.5 Provider firms should consider the needs of the retail consumer at the end of the supply chain regardless of the distribution strategy that they are using. Distributors should not be regarded as the ‘end customer’.
- 10.6 Firms should review whether distribution in practice corresponds to what was originally planned or envisaged for distributing their products, given the target market. This involves collecting and analysing appropriate MI so the firm can detect patterns in distribution compared with the planned target market, and can assess the performance of the channels through which its products are being distributed – see Post-sales responsibility.
- 10.7 Firms should carry out due diligence on distributors:
- initial due diligence would include an assessment of any risks posed to the fulfilment of the firm’s legal and regulatory responsibilities; and
 - continuing due diligence would include monitoring their distributors to ensure that products are reaching their target market.
- 10.8 Firms should act on their assessments of distributors: such action could include amending consumer or adviser literature for future product tranches, providing enhanced training for distributors, ceasing to use a particular distribution channel, or limiting distribution to specific channels.
- 10.9 Firms should consider whether they should take any remedial action if there are serious problems, e.g. reviewing sales of other products within the distribution channel or investigating a particular distributor.
- Strong sales should not be seen necessarily as a positive measure of treating customers fairly: higher than expected sales might in fact be an indication that a product is not reaching only the target market envisaged for it. Firms should assess unexpected spikes in sales, analyse the reasons for this, and take this information into account in future product design.
 - Where relevant, firms should consider how they reward in-house sales forces, whether the reward arrangements increase the risk of mis-selling and whether any risks are adequately controlled.

11 Information to distributors

Findings

- 11.1 Firms believed that both financial advisers and in-house sales staff had a good level of knowledge and understanding of structured products. They also felt that most current product structures and pay-off profiles were relatively simple and that financial advisers were unlikely to need significant levels of information or training. A number of firms that regarded their structured investment products as relatively simple did so in relation to other complex investments, or to wholesale structures, which we felt was an inappropriate comparison.
- 11.2 The level of training and ongoing support therefore varied significantly across the sample. A number of firms felt that the information contained in customer literature was sufficient for distributors to understand the product and its target market. In one case where a firm was distributing complex variations on existing products through intermediaries, the firm had provided those intermediaries with general training on structured products but had not given them tailored training on particular products and their features.
- 11.3 Providers also did not inform distributors adequately about the types of target market they had identified for the product.

Actions for firms (relevant to all structured products)

- 11.4 Providers should bear in mind:
- the financial capability of their distributors;
 - that information provided to distributors has a different purpose from information provided to consumers;
 - the information disparity between themselves and the distributor due to the complex financial engineering and market analysis behind their products; and
 - the fact that distributors are unlikely to be able to access this information on their own.
- 11.5 Firms should not rely on financial promotions to meet their obligations in this area – the information needs of consumers and distributors are different. This should be reflected in the content of communications, including the range and detail of technical information, which will usually need to be greater for distributors.
- 11.6 Complex product structures and features may be difficult for sales staff or intermediaries to understand and to explain to retail customers. Firms should therefore ensure that they provide information to the distributor base that can be understood by the recipients with the lowest level of knowledge.

- 11.7 Firms should provide appropriate information and in sufficient detail to distributors on the product structure, its implicit charges (such as structuring costs which are built into the product and which are ‘paid off’ through its life) and the market conditions required to generate various outcomes. They should also clearly flag key risks and limitations, as well as potential pay-offs, to help distributors:
- understand the product and its target market;
 - make a fair comparison between a structured investment product and other retail solutions that may be available;
 - understand the price that is being paid for any capital protection as part of the product’s risk/reward profile; and
 - understand the circumstances in which a product will perform and ‘do what it says on the tin’.
- 11.8 Firms should assess the nature and complexity of the product to determine the likely training needs and other support required by distributors. Complexity should be considered in relation to other retail products and solutions rather than to wholesale activity or structures.
- 11.9 Training is a powerful tool in helping distributors to understand products. The primary purpose of training should be educational and it should not be used as a marketing tool, or product ‘push’. The content of training presentations should be sufficient, appropriate and comprehensible and should not diminish the risks of a particular product by focusing on features that are designed to offer protection.

12 Information to consumers

Findings

- 12.1 Generally, firms across the sample had heeded our previous guidance on financial promotions for structured investment products²² and were broadly complying with the expectations that we had communicated to the industry. There has been a significant improvement in the overall quality of financial promotions since 2009 in the key areas we had raised, such as capital-at-risk and counterparty risk warnings. Systems and controls seem to be robust and firms were familiar with FSA intervention in this area. A number of firms had carried out independent testing to assess consumer understanding of their financial promotions and had made changes to their literature to take account of the results.
- 12.2 However, there are a number of issues that we believe require further communication and highlighting to the industry. We have noticed a tendency to advertise rates of return as a headline rate (such as ‘earn up to 60%’) where these are in fact limits on the returns achievable, and where any return at all depends on the performance of an index.
- 12.3 We noted also that complex or opaque product features and pay-off profiles such as averaging²³, cliquets²⁴ (which are found in structured deposits as much as structured investment products) and collateralisation could be very difficult for firms to explain to consumers in promotional material.

Good practice

- 12.4 A firm in our sample carried out a detailed post-sales review to assess the effectiveness of sales processes and information that they had provided to consumers. A sample of consumers were contacted after their purchase and asked about key elements of the product that they had invested in. The research revealed that a significant minority of consumers who had subscribed to a tranche had not fully understood the complex return mechanism/participation rate that applied to the relevant product.
- 12.5 A wider review was then carried out to test the understanding of customers across the tranche. Disclosures in consumer material were revised and new wording was tested on focus groups. Although comprehension levels increased, new research showed that certain consumer groups still failed to understand the product adequately. While the research had initially been intended to test the effectiveness of promotional literature, the firm concluded that the nature and complexity of the particular product feature was inconsistent with the average financial capability of target

²² *Fair, clear and not misleading: review of the quality of financial promotions in the structured investments products marketplace*, October 2009

http://www.fsa.gov.uk/pages/Library/Other_publications/structured/index.shtml

²³ Where a pay-off is triggered by the value of an index or security at the end of a term, averaging refers to taking an average value of the index or security from a number of measurements, for example end-of-month values over the last year of the term. This reduces the impact on the pay-off of a sudden rise or fall in values at the very end of the term.

²⁴ A cliquet is where the pay-off is based on the value of a reference index or security over successive shorter periods within the product term, usually with a cap on the maximum return from each shorter period.

customers. They were also concerned about their ability to present key information in a way that was fair, clear and not misleading. The relevant feature was accordingly removed from the product altogether.

Actions for firms (relevant to all structured products, except where marked otherwise)

- 12.6 Firms should bear in mind TCF Outcome 3: *Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.*
- 12.7 Firms should not rely on financial promotions to remedy earlier failings in the product development process.
- 12.8 Firms should assess both the nature and complexity of a product, and the financial capability of its target market, to determine the likely information needs of consumers. The more complex a product's structure and features are, the more difficult it is likely to be to explain in a financial promotion without risk of consumer misunderstanding.
- 12.9 Firms should promote the features of their products in a fair and balanced way. In particular, firms should:
- clearly distinguish between the benefits that apply to a product wrapper and those that relate to the product itself. For example, firms should not imply that the product itself offers tax benefits where these are in fact provided by the use of an ISA wrapper;
 - give a balanced impression of the prospects for achieving maximum returns, where these are promoted. Maximum returns should be realistic and should not be the most prominent feature of a promotion;
 - consider promotion of maximum returns in the light of their overall obligation to be fair, clear and not misleading. So, the possibility of achieving a less-than-maximum return, including the simple return of capital with no additional reward, should be clearly and fairly set out;
 - present any cap on participation rates²⁵ in a way which is fair, clear and not misleading;
 - not imply that product performance relates to market movements throughout the entire term if it does not, for instance if it relates to the level of the index at a set point or points in time at or near the end of the term;
 - ensure that the implications of averaging, including the benefits and disadvantages, are clearly stated in promotional material; and

²⁵ Participation caps are effectively limits on the amount of growth in the relevant index (or other reference measure) that the customer can access, e.g. if a participation cap is set at 60% over five years then a consumer will not be able to receive a higher return than that during the investment term, even if the actual growth of the index in the same period is significantly higher.

- make clear (where applicable) that the product is designed for a set maturity date, and early exit charges may apply.
- 12.10 *For structured deposits*, annual equivalent rates (AERs) should be clearly and prominently stated wherever possible, and should be no less prominent than the promotion of minimum and maximum returns over the life of the product.
- 12.11 The availability or otherwise of cover by the Financial Services Compensation Scheme (FSCS) (or another EU guarantee scheme) can be a key factor in a consumer's decision to purchase any product (see **Identification of target markets and idea generation**, above). Where structured products are covered by the FSCS (or another EU guarantee scheme), firms should include a statement which sets out clearly the level of cover afforded and where additional information about the cover can be obtained. This is particularly important in the case of structured investment products, which are only likely to be eligible for cover in a limited range of circumstances.

13 Post-sales responsibility

Findings

- 13.1 Although the majority of firms in our sample were monitoring products post-sale, it was not always clear what criteria they were using and why. This was linked to weaknesses in target market identification and stress-testing processes earlier in the product design cycle.
- 13.2 Not all firms had considered what kinds of strategy they would use to contact customers and distributors in the event of a market event that affected a product, or a situation when a product would be likely to fail to perform as investors and distributors had been led to expect.
- 13.3 In a number of cases, firms had implemented early redemption procedures that allowed potentially long delays between the submission of irrevocable redemption requests or preliminary valuations and final redemptions. This meant that consumers could not be certain of the amount that they would receive on early redemption and increased the risk of a significant market movement to their detriment.
- 13.4 A number of firms had chosen to outsource their administrative processes to third party firms and so had to rely on them for some key post-sales information and customer-facing activities (such as dealing with queries). This clearly increases control risks.

Good practice

- 13.5 One firm was monitoring live products on a regular basis in 2009. Some of the products were backed by securities that were being badly affected by the continuing global economic crisis. The firm accordingly restructured a number of products to minimise the impact to investors, avoiding significant losses of capital and ensuring that products suffered minimal losses. All key internal stakeholders were involved in making this decision and we saw evidence that the firm had carefully considered the implications of taking action and weighed them against the consequences of allowing the markets to run their course. A detailed customer and adviser contact strategy was implemented to ensure that the firm communicated with customers in a way that was fair, clear and not misleading. The product design process was also amended for later structures to reduce the amount of correlation between asset classes or issuers in relation to particular products to minimise the chance of such issues occurring again.

Actions for firms (relevant to all structured products)

- 13.6 Firms should bear in mind TCF Outcome 6: *Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.*
- 13.7 Firms should periodically review their products to check:
- whether the product is continuing to meet the needs of the target audience that it was designed for; and

- whether the product's performance will be significantly different from what was originally expected and communicated to the distributor or customer before the sale.
- 13.8 Firms should be able to clearly articulate the criteria that such assessments are made against.
- 13.9 Firms should consider the strategy they would use to contact customers and distributors in the event of a market event that affected a product, or a situation when a product would be likely to fail to perform as investors and distributors had been led to expect.
- 13.10 Firms should use both proactive and reactive post-sale information to make any necessary changes to the product development process, including target market identification and product stress-testing. Post-sales MI such as high levels of cancellations or early redemptions may indicate broader issues such as a lack of consumer understanding of the product or problems in the distribution channel used.
- 13.11 Where a product review discloses issues with a product (such as a mis-match with the needs of the target audience, or a significantly different performance from that advertised), the provider should also consider what action to take for existing customers, such as whether to inform them of the development; whether to restructure the product; or whether (where applicable) to cease marketing further tranches. Firms should clearly assess the likely consequences of each option for customers against the risk of doing nothing. They should also be mindful of the impact that any communication that they make could have, for example the potential for consumers to exit the product early and crystallise any loss.
- 13.12 Firms should ensure that they treat customers fairly throughout the life of a product. In particular, firms should be mindful that customers may wish to exit products early and should put in place redemption mechanisms that allow this to happen smoothly, with minimum uncertainty for consumers. Firms should consider the impact of long delays between submission of redemption requests/valuations and actual redemption calculations to ensure that the time lapse is reasonable and does not place consumers at risk of significant changes to the value of their redemption.
- 13.13 Firms should continue to provide support and help to distributors and customers during the product lifecycle. They should allow sufficient resources to deal with ongoing queries.
- 13.14 We remind firms that they retain regulatory responsibility for activities that are outsourced to third parties. Firms should carry out due diligence when selecting such third parties, and keep performance under regular review, ensuring that both they and the third party have appropriate systems and controls in place to manage and mitigate any relevant risks.

Annex 1 Product design and stress-testing

Actions for firms – technical aspects of stress-tests (all structured products, except where marked otherwise)

i) General

- A1.1 Stress-tests should be forward-looking as well as back-testing, given the limited value of ‘past performance’.
- A1.2 Stress-tests should analyse the resilience of the product over its proposed term so that the firm can consider the target market accordingly, including particularly its risk profile.
- A1.3 Where there is a value for money test, such as a comparison with cash, there should be a sufficiently demanding hurdle rate to reflect the opportunity cost of the ‘next best’ use of the customer’s money.

ii) Quantitative modelling (simulation) and collateral management

- A1.4 Firms should clearly distinguish simulation and stress-testing at the creation of the product from collateral management throughout the life of the product.
- A1.5 **Simulations** should be carried out to understand the expected profitability of the product from the investor’s point of view. Since a structured product is constructed with a view to generating different potential outcomes, those same outcomes can be graded in terms of probability.
- While a cash comparison tool is appropriate for structured deposits, in the case of an investment product with a more volatile underlying such as equity index, a forecasting measure is more appropriate. There should be a policy determining minimum acceptable thresholds for the positive outcomes.
 - However, any such simulations (and the policy framework within which they are run) should ensure that there is not an excessive focus on asset classes and indices that have generated high recent returns (and hence have headline returns that are highly marketable to investors), even though these high recent returns may be a sign of potential reversal of the trend of such returns in these same asset classes or indices.
 - Stress-test assumption sets incorporating correlations between market variables, together with broader economic assumptions, may be useful in establishing such a policy framework. Firms should establish thresholds on the probability of stressed outcomes that are likely to be acceptable to the target audience.

A1.6 **Collateral management (for structured investment products)** should form part of robust practice in a firm's prudential risk management and include an ordered, comprehensive, and documented process. In particular, the collateral management for structured products should focus on:

- **Liquidity:** any collateral posted should have transparent pricing, and a settlement cycle no longer than the date of expiration of the product and/or in line with redemption dates. The assets should be easily convertible into cash at those key dates. The greater the actual or potential maturity mismatch between the collateral and the redemption dates of the product, the more important it is to ensure liquidity in the underlying collateral.
- **Valuation:** collateral must be capable of being valued independently of the structure of the product, although in relation to the liabilities embedded by the issuing institution.
- **Issuer credit quality:** the credit quality of the collateral issuer is an important element. The firm's internal policy should require minimum credit quality requirements (e.g. minimum credit ratings) of the instruments, and require the revision of haircuts in certain circumstances (e.g. downgrade of the issuer credit rating) in the event of downgrades. The credit quality should be monitored continually and not just at issuance.
- **Credit support annexes:** any credit support annex (CSA), be it a 'one-way' or 'two-way' CSA, should ensure that collateral is posted to the product by the hedge counterparty and/or seller of the product, and that this collateral posting covers both the principal component of the product (in case, for example, the value of the collateral declines due to deterioration in credit quality) and also the return component of the product (in case, for example, the derivative that provides the pay-off to investors becomes in-the-money to the product).
- **Segregation:** the collateral backing the product should also be appropriately segregated via the legal structure of such product, so that it could not fall into the bankruptcy estate of the seller of the product provider, thus rendering ineffective the product's capital protection.
- **Asset concentration:** firms should embed some limits on asset concentration (for instance, limiting concentration in any one issue, sector or country, where this would introduce excessive credit risk), use prudent discount rates for valuation, and ensure they identify specific operational and legal risks.

Annex 2 Contract terms

- A2.1 The Unfair Terms in Consumer Contracts Regulations 1999 (the Regulations) apply to standard-form consumer contract terms which have not been individually negotiated with consumers. The Regulations apply to contracts entered into since 1 July 1995 and, under the Regulations, unfair terms are unenforceable against the consumer.²⁶ The FSA is a qualifying body under the Regulations and, as such, can challenge firms that use unfair terms and/or terms that are not written in plain and intelligible language.
- A2.2 Ultimately, only a court can determine the fairness of a term and, therefore, we do not recommend terms that have been revised by a firm to address our concerns as being definitely fair. We cannot approve terms for the purposes of the Regulations; it is for firms to make an assessment of the fairness of their terms and conditions under the Regulations and in the context of the product or service in question. It is important to bear in mind that wording that is fair in one particular agreement is not necessarily fair in another.²⁷

Terms reviewed

- A2.3 We have identified terms within a review of structured products contracts that we consider are likely to be unfair under Regulation 5 and/or are not, in our view, expressed in plain and intelligible language in accordance with the requirements of Regulation 7.
- A2.4 We have reviewed the terms and conditions of four of the seven firms which formed part of this overall review. The particular sample was selected as it provided a good range of the types of products in this area and the issues that may arise with the fairness of terms in the structured product market. This review focuses on key issues of concern and is not intended to be a definitive review of all terms and conditions in use across the structured product market. Firms are responsible for assessing the fairness of the terms in their contracts, in accordance with applicable legislation and FSA Rules.

²⁶ The overarching test of fairness is in Regulation 5 and provides that a term will be unfair if “contrary to the requirement of good faith, it causes a significant imbalance in the parties’ rights and obligations arising under the contract to the detriment of the consumer.”

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

²⁷ Our views in this communication are not Handbook text and do not constitute general guidance on rules under FSMA. It reflects our view of the statutory obligations that have existed under the Regulations since 1995 and existing regulatory obligations rather than adding to them. The views here are not of themselves enforceable against firms, but we would expect to have regard to them when exercising our powers under the Regulations. For further information about the FSA’s view of its powers under the Regulations, please see the information in the Unfair Contract Terms Regulatory Guide (UNFCOG).

A2.5 We focused our review on three types of terms²⁸:

- exit terms;
- termination terms; and
- variation terms.

Exit terms

A2.6 As part of our review, we noted that, broadly, there were two types of exit terms in structured products contracts which had particular potential to be unfair:

1. terms that required a consumer to pay a fee in order to exit the contract early; and
2. terms which provided that, on exit by a consumer, the firm would sell the underlying securities in the structured product and refund the proceeds of the consumer's investment to the consumer.

A2.7 For the purposes of this communication, references to 'Exit Charges' should be taken as references to both (1) and (2) above.

Key findings

A2.8 Firms did not always make clear in the terms and conditions how the Exit Charges would be calculated. We considered that such terms were likely to be unfair, as they resulted in uncertainty for consumers and appeared to allow a wide discretion for firms to determine how much should be paid to consumers on exit. We considered that this could cause detriment to consumers as they might receive an amount lower than they had been led to expect.

A2.9 In the contracts of some firms, the terms and conditions relating to a consumer's ability to exit the contract (and the potential charges and/or losses associated with this exit) were spread out across the contract, resulting in it being necessary for the consumer to look at several terms and conditions in order to understand the position. We considered that this could result in the terms not being plain and intelligible.

A2.10 Generally, a consumer could exercise their right to exit in a variety of different circumstances. For example, a consumer could opt to exit the contract entirely. Some firms also offered the option for consumers to withdraw or transfer part of their investment. It was not always clear whether all such circumstances would trigger an exit fee and result in a consumer paying an exit charge and/or result in a loss for the consumer as a result of the firm selling securities at a lower value than the price of the consumer's initial investment.

²⁸ Although we have focused our review on these terms, this does not mean that we consider all other contractual terms in structured products contracts to be unlikely to be unfair and we recommend that these are regularly reviewed in line with the Regulations and any undertakings and guidance published on the FSA's website. Following this communication, firms may wish to consider conducting a wider review of their terms and conditions in order to satisfy themselves that these are not unfair.

Key messages

- A2.11 We consider that firms could do more to make their exit terms less likely to be unfair and more plain and intelligible under the Regulations. Of course we are aware that the nature of the products and the potential fluctuations in the market may enable a firm to form the view that it is not possible to specify the exact level of charge that a consumer may incur. Nonetheless, where a precise charge cannot be stated, we would expect the term to make it clear how it will be set, perhaps, for example, by setting out the factors that may be taken into account when calculating an exit fee²⁹.
- A2.12 Placing information about a particular type of term (for example terms relating to termination of the contract) in one section in the contract is more likely to make terms plain and intelligible to consumers.
- A2.13 Firms should consider the various circumstances in which early exit may be triggered under the terms (such as partial withdrawal and transfer) and ensure that the consequences of this are clearly set out and are plain and intelligible to consumers.

Termination terms

Key findings

- A2.14 Some firms provided themselves with broad discretion to terminate the contract for a consumer's breach of the agreement. This right to terminate did not appear to depend upon the seriousness of the consumer's breach, which we considered is likely to be unfair under the Regulations. This is because, in our view, the terms setting out this right gave too much power to firms to terminate the contract for a relatively minor breach of contract, thereby creating a significant imbalance in the parties' rights and obligations to the detriment of the consumer.

Key messages

- A2.15 Where a term provides a firm with discretion to terminate a contract following a breach of the terms and conditions by a consumer, we consider that this discretion should be causally linked to the materiality of the consumer's breach³⁰.

Variation terms

Key Findings

- A2.16 The FSA has already published a Statement of Good Practice in relation to the drafting of variation terms³¹ by financial services firms in general and so we do not intend to comment on

²⁹ See further the OFT Guidance on Unfair Contract Terms, September 2008.

³⁰ See the National Australia Bank Undertaking, published in January 2009:
http://www.fsa.gov.uk/pubs/other/undertaking_nab.pdf

³¹ <http://fsahandbook.info/FSA/html/handbook/UNFCOG>

variation terms in the structured product market in great detail. We note that Schedule 2, paragraph 1(j) of the Regulations indicates that a term may be regarded as unfair if it allows the firm to change unilaterally the terms of the contract, without specifying a valid reason. We noted, as part of our review, that some firms had variation terms that did not reflect the position as set out in our Statement of Good Practice.

Key messages

- A2.17 Schedule 2 of the Regulations indicates that a variation clause is less likely to be regarded as unfair if it can only be made with a valid reason specified in the contract and we would expect firms to have due regard to this when drafting contract terms. However, as mentioned in our Statement of Good Practice, we consider that fairness should be assessed in light of the Regulations as a whole and, for example, just specifying a valid reason in the contract may not go far enough towards satisfying the test of fairness. It may also be necessary, for example, to provide for notice to consumers that a change has been, or will be, made. Therefore, in circumstances where it is possible to give notice, firms may wish to provide in their contracts that they will do so, in order to further mitigate the risk of terms being likely to be unfair.
- A2.18 We also expect firms, as part of their systems and controls and as a matter of good practice, to review the undertakings and guidance on the FSA's website regularly.

Information contained in the terms and conditions and any accompanying brochure

Key findings

- A2.19 We noted that some firms set out more detailed information about their structured product in a brochure that accompanied the terms and conditions, rather than in the terms and conditions themselves. We also noted that, in some instances, the terms and conditions referenced particular sections from the brochure. In such circumstances, the brochure is likely to form part of the contract between the consumer and the firm, with the result that all or part of a firm's brochure may become assessable for fairness under the Regulations.

Key messages

- A2.20 Where a firm intends that provisions in the brochure should be part of a contract, the link and/or the reference to the relevant section of the brochure should be clearly set out within the terms and conditions. In relation to whether the brochure then becomes assessable under the Regulations, a firm may wish to bear this in mind when drafting terms and conditions and/or any accompanying brochures.

Annex 3 Cost benefit analysis

Introduction

- A3.1 We set out below our cost benefit analysis (CBA) of the proposed guidance on Structured Product Development and Governance. This should be read in conjunction with the proposed guidance.
- A3.2 FSMA does not require us to perform a CBA for guidance. However, 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.³²
- A3.3 Our guidance relates to our Principles of Business and certain of our existing COBS, BCOBS and SYSC rules. The guidance is forward-looking, so we do not expect firms to proactively review existing products, other than under their current arrangements. Given the market practice we have observed in our thematic work it was apparent that many of our proposed actions for firms have already been considered and in the main, adopted by firms as part of the embedding process for TCF. However, some of the actions proposed could generate significant cost to firms that were not formally considered at the time we consulted on the rules to which the guidance relates. The actions that could generate significant costs include those on TCF outcomes and product stress-testing and modelling.
- A3.4 The guidance on unfair contract terms relates to UTCCRS, and is not subject to CBA or consultation by the FSA. Annex 5 concerns the Prospectus Directive and Prospectus Rules (PRs): to the extent that this constitutes guidance on rules, we rely on the CBA carried out at the time of the consultation and set out in CP 04/16.
- A3.5 The CBA is set out as follows:
- a brief description of the firms that will be affected by the proposed guidance;
 - the market failures addressed by the proposed guidance;
 - estimates of the costs of our guidance broken down by each area;
 - identification of indirect costs; and
 - analysis of benefits.

³² See http://www.fsa.gov.uk/Pages/Library/Policy/guidance_consultations/new_process/index.shtml

Firms affected by proposed guidance

A3.6 The proposed guidance that is contained in this consultation applies to manufacturers of structured products. We estimate there are around 64 provider firms.

Market failures

A3.7 From our thematic research on the structured product market and as evidenced by the detail of our findings, we have identified potential detriment to consumers. Detriment to consumers is caused through design and development weaknesses, and manifests itself in the following ways:

- product providers lack sufficient incentives to target products to consumer needs, since this involves some costs, such as research and review of management information.
- product providers can give inadequate consideration to the information needs of consumers during the design process, hampering consumers' understanding of products;
- consumers are unable to judge the value and quality of products because of opaque and/or complex product features, which can be inadequately communicated by product providers and intermediaries;
- ultimately, these problems give rise to the risk of a poor match between consumers' needs and the products they purchase.

A3.8 Consumers can experience other problems once they have made a purchase:

- as structured products are designed as medium to long term illiquid investments, it is important that providers ensure products are delivered to the appropriate target market, as customers will normally be 'locked-in' to a purchase once made; and
- consumers may experience detriment if the design of the product is such that there are delays or value adjustments when investments are redeemed early.

A3.9 We have previously sought to address the problems identified through our October 2009 publications on *Fair, clear and not misleading: review of the quality of financial promotions in the structured investments products marketplace* and *Treating Customers Fairly – Structured Investment Products*. These publications focused on improving the quality and transparency of product information as well as encouraging product providers to invest more in ensuring that products are matched to the needs of their consumers.

A3.10 Our recent thematic work has shown that, while improvements have been made, particularly in the area of financial promotions, there remains work to be done to improve product development and governance.

A3.11 In the absence of any regulatory action, the market failures and risks to the FSA objective of consumer protection as discussed above are unlikely to disappear.

Direct costs

A3.12 The FSA will not incur significant costs from publishing the guidance. However, there could be costs generated in the form of supervisory time spent on assessing firms' product development and governance arrangements with the benefit of this guidance. The prioritisation and resource allocation for this work will be dictated by the use of the ARROW methodology, which is in place to ensure that, from all the risks applicable to a firm, only the highest priority firm risks are assessed by supervision, due to the finite amount of resource available. Therefore, we see these costs to the FSA as being subsumed into business as usual.

Compliance costs

TCF outcomes

A3.13 The majority of potential compliance costs stem from product providers embedding TCF outcomes in the product design and development process. LECG³³ reviewed the costs of retail investment product providers embedding TCF outcomes in compliance with Principle 6 in 2008. It found that firms incurred varying costs because they started from different levels of compliance and undertook differing routes to compliance. Some firms needed to make few changes to become compliant. Others incurred more significant costs. Their estimates are an average of these varying costs.

A3.14 From what we saw in the thematic work, firms may need to make similar change to those recorded in the LECG report if they follow the actions in this guidance. We expect that costs would vary in a similar way as well. We have used the estimates from LECG's report for this CBA. It is important to note, however, that, in many areas, firms have already embedded the costs of TCF. So while costs may be generated in some areas as a result of this guidance, many improvements are deemed likely to be achievable via a re-distribution of resource as opposed to the costs of obtaining new resource. Our estimates could, therefore, overestimate the costs experienced by firms if they follow the actions in the guidance.

A3.15 The table below sets out the previously estimated ongoing and one-off costs of embedding TCF outcomes in compliance with Principle 6, per 1,000 products sold:

³³ LECG - The Law and Economics Consulting Group: a firm which provided research commissioned by the FSA to estimate the cost impact of recent changes to the regulation of retail investment products, including the cost of embedding the FSA's Treating Customers Fairly initiative.

Table 1.1 Average deferred incremental costs resulting from embedding TCF outcomes reported by manufacturers (£ per 1000 sales)³⁴

£ per 1,000 products sold	One-off cost	Ongoing Cost
Product development	10	430
Marketing and promotion	230	1,180
Distribution and support to intermediaries	80	10
Sales and advice	30	0
After-sales service	90	450
Complaints handling	550	110
Governance, strategy and planning	1,660	210
Financial management and reporting	80	200
Human resources	760	520

A3.16 For each area of the guidance, we set out below where potential costs may be incurred.

A3.17 Where existing FSA rules are cited we refer to our estimates of compliance costs from the relevant consultation. For SYSC the CBA is set out in CP 06/9, for COBS it is in CP 06/19 and for BCOBS it is in CP 08/19.

Business models

A3.18 The action for firms to have adequate controls around the development and marketing of products reflects an existing requirement of SYSC rules. The costs of compliance were included in CP06/09, which revealed that firms would not experience significant compliance costs, given their current practice.

A3.19 The cost for firms to embed TCF in Product Development is covered by the Product Development costs estimates in Table 1.1. These include the cost estimates for more consumer testing, which are mainly ongoing costs, amounting to about £40,000 per firm on average. Where a firm needs to improve governance arrangements, the estimated costs for Governance, Strategy and Planning may also apply, which include the one-off costs of reviewing strategy and the ongoing costs of more senior management discussions of TCF outcomes, estimated to be £150,000 and £20,000 per firm respectively. These costs are likely to be overestimates since they were based on reviewing all retail investment products, not just structured products.

Product approval procedures

A3.20 From our thematic review we found that firms were in general devoting an appropriate amount and quality of resource to product approval, but that there was variation in practice across the approval of individual products. The actions reflect either an existing requirement of SYSC, the costs of which were included in CP06/09, or related to meeting TCF outcomes. These costs are included in the estimated costs for Product Development and Governance Strategy and Planning

³⁴ Based on LECG (2009) The Regulation of Retail Investment

in Table 1.1, which include the one-off and ongoing costs of senior management review of TCF outcomes.

Identification of target markets and idea generation

- A3.21 We expect firms to incur costs in relation to the embedding of TCF Outcome 2 in the identification of target markets and idea generation, which are covered in Table 1.1.
- A3.22 The LECG review revealed that some manufacturers had increased their level of consumer testing for their products as a means to facilitate embedding TCF. As noted above, the average ongoing cost was in the region of £40,000 per firm.
- A3.23 Firms could incur costs from more review by senior management of the factors relevant for target market selection. These costs are captured in the ongoing costs recorded under Governance, Strategy and Planning. Senior management could play a greater role in the review of management information on the performance of products in the market, and whether they continue to serve their intended target market. The one-off costs of adapting management information reporting and the ongoing costs of reviewing it are included in the Financial Management and Reporting costs in Table 1.1. The ongoing costs amounted to £20,000 per firm on average.

Design and development of product features

- A3.24 Firms could undertake more consumer testing of products, including their understanding of product features. The ongoing cost of this is included in our estimates under Product Development in Table 1.1. The design of the product, including how returns are distributed, would be informed by the results of stress-testing the product from the consumers' perspective, the costs of which are included in the next sub-section.
- A3.25 The action for firms to exercise care for linked sales is likely to apply only to products sold by tied financial advisors in banks. The LECG report included costs for bancassurers monitoring sales made by staff. LECG estimated these ongoing costs to be £30 per 1,000 sales, or approximately £5,000 per firm on average.
- A3.26 The cost of additional due diligence on counterparties is likely to be minimal since this work is likely to be part of firms' wider financial risk management processes, typically through the work of firms' Asset and Liability Committees. The cost of considering the output of these meetings in counterparty selection for structured investments products is deemed to be minimal since the information is likely to be already collected by the firm.
- A3.27 The action for firms to choose underlying instruments or indices to meet consumer needs should not generate additional costs for firms since our guidance is forward looking. Firms will have the opportunity to design products that take this action into account along with other actions to target products to consumer needs, and will be able to develop their products accordingly.
- A3.28 Similarly, firms will also have the opportunity to consider the TCF impacts of product lead times on customers for their future product design. Consequently the associated action should not generate additional and immediate costs for firms.

Stress-testing and modelling

- A3.29 We expect firms to incur additional costs in relation to stress-testing and modelling, which are not covered in Table 1.1.
- A3.30 We estimate that the incremental ongoing cost to firms of structured product stress-testing and modelling actions is approximately £1,200 per product. This cost was estimated by a third party outsourcing firm and reflects the cost of consultancy, analysis and reporting. Furthermore, we expect the majority of firms to be able to modify existing stress-testing procedures that are already in place to follow our latest guidance on stress-testing and modelling, i.e. for these firms the additional cost is not expected to be significant.
- A3.31 Our estimates in Table 1.1 include the ongoing costs of more senior management time devoted to reviewing management information and governance with a focus on TCF outcomes. Furthermore, the costs reported by bancassurers in LECG's study for greater use of compliance approval checks for TCF during product development did not indicate a material increase in the costs of developing products, so we would not expect the costs of reviewing stress test results to add significantly to the costs of product approval.
- A3.32 We expect that stress-testing on how firms' operational risks impact on structured product performance will be considered through holistic operational risk management and not on a product-by-product basis, so we do not expect this action to generate significant costs.
- A3.33 In our technical guidance for firms at Annex 1, we distinguish between quantitative modelling (simulation) and collateral management. For simulation, our estimate of any additional costs is included within the costs outlined above. For collateral management, as our guidance sets out ways in which firms should manage collateral, where it is used, we do not envisage any additional costs for those new products that do not use collateral. For new products that use collateral there may be an opportunity cost if firms would have designed their products with collateral arrangements that differ from our guidance. Firms can, however, incorporate our guidance in the design and pricing of new products, since it is forward looking.

Selection and monitoring of distribution channels

- A3.34 We expect firms to act on the management information they receive for current products in line with their current business practice. For future products and distribution, firms could incur costs from collecting and reviewing more management information. Our estimates of these one-off and ongoing costs are included in the category of Financial Management and Reporting. In LECG's report the average ongoing cost of collating and reviewing MI was £20,000 per firm.
- A3.35 To the extent that this reveals problems with distribution then firms could need to undertake remedial action. One action is to provide more training to distributors. The cost of increased training was captured by the LECG report. In the area of 'Distribution and support to intermediaries', half the manufacturers interviewed as part of the LECG review had increased the

time they spent training distributors about the impact of TCF through workshops. The average ongoing cost was in the region of £10,000 per firm.³⁵

A3.36 Another remedial action would be to update product literature. The estimates of these costs are included under the following sub-section, ‘Information to distributors and information to consumers’.

A3.37 In more extreme cases firms may wish to cease or limit the use of particular distributors. We would expect the number of such cases to be rare given increased reviews of management information feeding into the product design stage, which should help address mismatches between the type of product and the needs of the target market. Where problems do arise these are more likely to relate to distributors not following the terms of the agreement with the product provider, which we would expect product providers to address as part of their normal business practice.

A3.38 This guidance may cause firms to review their remuneration and reward strategies; however, we would expect that these strategies are reviewed periodically as a matter of business as usual.

Information to distributors and Information to consumers

A3.39 This guidance is related to existing requirements under COBS and BCOBS (for Structured Deposits). The consultation on reforming conduct of business regulation in 2006 did not expect material costs of compliance for financial promotion rules, given firms’ existing practices.³⁶ Costs of compliance with banking conduct of business regulation were included in the consultation on the draft rules.³⁷

A3.40 Where a firm takes action to improve the quality of material distributed to advisers, we would not expect this to cost more than providing training or information sessions to advisers, the costs of which are included in the category Distribution and Support to Intermediaries and Marketing and Distribution in Table 1.1. Were this not the case then firms would opt to provide this type of support since it would cost less.

Post-sales responsibility

A3.41 The majority of this guidance reflects an existing requirement of SYSC, the costs of which were included in the consultation paper, Organisational Systems and Controls: Common Platform for Firms.³⁸

A3.42 As a result of this guidance, firms may spend more time reviewing TCF management information. Our cost estimates for the collation and review of management information are included in the categories of Governance, Strategy and Planning and Financial Management and Reporting.

³⁵ LECG classified these costs as one-off, but it seems reasonable that training provided for advisers would be an ongoing activity.

³⁶ FSA (2006) Reforming Conduct of Business Regulation, CP06/19

³⁷ FSA (2008) Regulating Retail Banking Conduct of Business, CP08/19

³⁸ FSA (2006) *Organisational Systems and Controls: Common Platform for Firms*

A3.43 We are not requiring firms to proactively review existing products, other than under their current arrangements. We would not expect firms to incur significant costs over and above those arising from remedying problems revealed by the assessment of management information. For new products, enhanced product design should limit the extent to which post-sales action to remedy problems is needed. Enhanced stress-testing would also help firms to price products to take into account the risk of needing to respond to problems with a product's performance relative to that expected, and to reflect these costs in their pricing.

A3.44 This guidance may cause firms to review their procedures for dealing with their clients' redemption requests in a timely manner. We do not expect firms to incur significant costs in this respect as the mechanisms to facilitate early redemptions should already be in place.

Indirect costs

A3.45 The costs we have estimated for product providers to follow our guidance are not sufficiently large as to be likely to cause a significantly detrimental impact on competition.

A3.46 Although this guidance would lead firms to identify narrower target markets for their products, we do not expect this to necessarily have a significant impact in sales volumes. We expect that firms will develop products which more closely meet consumer's needs.

Q: Do you agree with our cost estimates in respect of the proposed guidance?

Benefits

A3.47 We expect the key benefit of the guidance to be improved matching of products to consumer needs, through a greater awareness and embedding of TCF outcomes (in compliance with our Principles) within structured product design and distribution strategies.

A3.48 We expect this improvement to arise through the following processes:

- research focused on gaining a better understanding of consumers' needs and product providers providing more support for intermediaries, for instance through training;
- product providers making greater use of management information to improve the targeting of products, and to provide insight on whether products are being sold to the intended audience, and allowing appropriate action to be taken where this is not the case;
- firms adopting a regular and consistent approach to stress-testing, making products more robust and more likely to perform as intended. The stress-testing could help improve product design and targeting through a better understanding of the likely performance of products;
- more or better management information informing product design should enable firms to improve the matching of products. We would expect this to decrease the likelihood of problems for consumers arising and the need for firms to take remedial action. Nevertheless, improved

management information would help firms to identify better where action to address problems could be needed, and to take appropriate action; and

- increased clarity on our expectations of firms as a result of this guidance will help firms' supervisors to assess whether firms have sufficient oversight and control of the risks presented to consumers by structured products, improving the effectiveness of supervision.

Annex 4 Prospectus Rules

Requirement for a prospectus

- A4.1 The Prospectus Directive (PD) is the European legislation that sets out when a prospectus has to be produced when securities are offered to the public. FSMA and FSA rules transpose these requirements into UK legislation. Broadly speaking, when an issuer seeks admission to trading on any EU-regulated market of its securities, or where a body makes a public offer of securities, it must produce a prospectus that must be approved by the relevant national competent authority.
- A4.2 The obligation applies to defined categories of transferable securities, including shares in companies, bonds, and certain options, warrants and derivatives. An offer to the public is defined as a communication in any form giving sufficient information on the terms of the offer and the securities to be offered to enable investors to decide to purchase or subscribe for the securities.
- A4.3 Both the definitions of public offer and of transferable securities are very wide, and it is often the case that a marketing of a structured product represents a public offer of transferable securities.
- A4.4 In the UK the FSA performs the role of the competent authority for the purposes of the PD. The FSA's Prospectus Rules set out rules governing the process for approval and reproduces the requirements for the contents of a prospectus that are set out in an EU Regulation.
- A4.5 There are certain exemptions from the requirement to produce a prospectus, including exemptions for small offers, offers to professional investors and offers in wholesale size. The details can be found in s.86 and Schedule 11A of FSMA.
- A4.6 Experience shows that there are some important features of the PD regime that structured product providers need to be reminded of. Firstly, any person offering securities to the public may need to produce a prospectus, even if they are not the issuer of the securities. Secondly, as previously highlighted in the communication issued on structured products in October 2009, we disagree with the analysis put forward by certain structured product providers that withholding certain information (such as the name of the underlying issuer of securities that back the structured product) means there is no public offer.
- A4.7 We would strongly urge firms to seek legal advice if they are in doubt over the requirement to produce a prospectus.

Ability to rely on a prospectus

- A4.8 A prospectus is produced for a specific purpose (which will be described within the document) and is only valid for a limited period of time (PR 5.1).
- A4.9 A distributor may be able to rely on a prospectus prepared by the issuer if has the consent of the issuer in doing so. The circumstances in which this may be possible are described in Q.56 of the

Q&A document of the prospectus directive produced by the European Securities Market Authority³⁹. Ordinarily a promoter/distributor would be explicitly named in the prospectus itself. These requirements, which relate to what are known as retail cascade offers, will be formalised by amendments to the Prospectus Directive which are expected to be implemented in the UK by July 2012.

- A4.10 It is also important that the actual offer conducted is described in the prospectus. For example, one could not rely on a prospectus to conduct an offer when that prospectus was produced solely for the admission to trading of the securities in question (and the offer is not described in the document).
- A4.11 Depending on the structure of the offer, the distributor and its directors may be responsible for the contents of the prospectus.
- A4.12 Where a prospectus was produced in another EU jurisdiction, we would also highlight the need for certain formal steps (known as “passporting”) to be followed before it can be used to conduct an offer in the UK.

Marketing

- A4.13 Where a prospectus is required, advertisements for the securities must be consistent with the information in the prospectus and must highlight the availability of the prospectus (see PR 3.3.2 R and 3.3.3G).
- A4.14 Some, but not all advertisements relating to prospectuses are exempt from the financial promotion regime, provided they meet certain conditions⁴⁰.
- A4.15 Where a prospectus is required, advertisements for the securities must be consistent with the information in the prospectus and must highlight the availability of the prospectus (see PR 3.3.2 R and 3.3.3G). Where a firm is subject to both MiFID and the PD it will need to comply with both the MiFID information rules in COBS 4 and the prospectus advertising rules in PR.

Forthcoming changes

- A4.16 We would also like to highlight the changes that are being introduced as a result of the PD Amending Directive (Directive 2010/73 EU) which is expected to be fully implemented in the UK by July 2012. As mentioned above, the PD Amending Directive formalises the requirements for retail cascade offers, i.e. a situation where a security issued by one person is sold on by another.
- A4.17 The PD Amending Directive also changes some of the exemptions, for example increasing the size of an offer that may be made without a prospectus and raising the threshold above which an offer may be exempt because it is considered to be of wholesale size.

³⁹ <http://www.esma.europa.eu/>

⁴⁰ Article 71 FSMA 2000 (Financial Promotions) Order 2005

Annex 5 Rule references⁴¹

Section	Provides guidance on application of:
Business models	Principles 2, 3, and 6 SYSC 3.1.1R SYSC 4.1.1R
Product approval procedures	Principles 2, 3, 6 and 8 SYSC 3.1.1R SYSC 4.1.1R
<i>Product development</i>	
Identification of target markets and idea generation	Principles 2, 3 and 6
Design and development of product features	Principles 2, 3 and 6 SYSC 3.1.1R SYSC 4.1.1R
Stress-testing and modelling	Principles 2, 3 and, 6
<i>Marketing – distribution and communications</i>	
Selection and monitoring of distribution channels	Principles 2, 6 and 7 SYSC 3.1.1R SYSC 4.1.1R

⁴¹ The table needs to be read in the light of the particular applicability of the rules to different firms and different products (for example, in section 2 the reference to P8 relates only to the fourth bullet of the first action).

Section	Provides guidance on application of:
Information to distributors	Principle 2
Information to consumers	Principles 6 and 7 COBS 4.2.1R COBS 4.4.1R COBS 4.5.2R BCOBS 2.2.1R BCOBS 2.3.1R BCOBS 4.1.1R
Post-sales	
Post-sales responsibility	Principles 2, 3, 6 and 7 SYSC 3.1.1R SYSC 4.1.1R SYSC 8.1.6R
<i>Annexes</i>	
Annex 1: Product design and stress-testing	Principles 2, 3, and 6
Annex 4: Prospectus Rules	Prospectus Rules