CFA UK is a member society of

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Dear Jason,

The Chartered Financial Analyst Society of the UK (CFA UK) is pleased to respond to FSA's Discussion Paper DP 11/1 Product Intervention (DP).

CFA UK is concerned that trust and confidence in the financial services industry is at a low level. The promotion of higher professional and ethical standards and individuals' adherence to those standards will play an important part in restoring trust and confidence. CFA UK also believes that effective regulation has a key role in enhancing market integrity and thereby contributing to improving trust and confidence.

The society represents investment professionals in the UK, most of whom hold the CFA designation and work as front office investment professionals (managing portfolios, researching securities and advising on asset management). This response has been prepared by CFA UK's Professional Standards and Market Practices Committee, in consultation with CFA Institute. The society has not surveyed members in relation to the FSA's DP due to the extensive number of questions within the paper. Our responses mainly relate to investment products, we make a number of observations that we believe to be important and that we hope will be useful in directing the FSA's approach when it comes to achieving its policy objectives.

<u>About CFA UK and CFA Institute</u>

The CFA Society of the UK (CFA UK) represents the interests of more than 9,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than

100,000 members in 140 countries, of whom more than 90,000 hold the Chartered Financial Analyst (CFA) designation.

Opening remarks and context for the response

CFA UK welcomes the philosophy behind product intervention

CFA UK is concerned that trust and confidence in the financial services industry is at a low level. The promotion of higher professional and ethical standards and individuals' adherence to those standards will play an important part in restoring trust and confidence. CFA UK welcomes the FSA's approach to product intervention as a means of improving market integrity and thereby ensuring that firms place clients' interests first. CFA UK is supportive of the FSA's change in approach as it demonstrates the following progressive elements –

- Greater emphasis on the importance of supervision and enforcement as being a credible deterrent for inappropriate activities. This aligns with CFA UK's responses to the HM Treasury's consultations on the new regulatory framework[1] for financial services.

- Looking to be more proactive rather than reactive so that consumer detriment is greatly reduced.

- Acknowledging behavioural as well as market failures in addressing the issue of consumer detriment.

- The importance of product governance; perhaps future papers discussing this topic could be renamed Product Governance rather than Product Intervention.

- The DP demonstrates that the regulator is willing to learn the lessons from its past experiences; CFA UK has been concerned that market participants, including regulators, often suffer from financial amnesia.

CFA UK is concerned about the prospect of new rules

CFA UK is concerned that FSA is considering introducing more rules and regulations in its interventionist approach when in fact all it needs to do is supervise and enforce the rules it has in place already. The examples of consumer detriment set out in the DP such as split capital trusts and SCARPS took place prior to the financial crisis and highlighted the red flags in the system that were largely ignored. More recent examples of consumer detriment have been due to ineffective product governance rather than the products themselves. In addition, the examples of consumer detriment are more alarming as they have often come from established firms as well as new firms. Specifically, such developments highlighted three key issues –

1) The types of practices that caused significant consumer detriment and intensified during the crisis.

2) Inadequate product governance at a firm level; this in turn raises the issue of firms being willing to run regulatory risks.

[1] CFA UK response to "A new approach to financial regulation: judgment, focus and stability," can be found at https://secure.cfauk.org/assets/2028/HM_Treasury_response_final_version.pdf

3) Ineffective regulation – the regulator did not act in a timely manner, did not address the root cause of the consumer detriment and its actions did not provide a credible deterrent.

Product governance is the most important

Ensuring effective product governance will be crucial given that FSA research found many consumers in the UK lack the confidence and capability to make effective decisions about their money. The Gfk NOP research also found that consumers feel a lack of interest and engagement with financial matters and that they do not feel fairly treated by the industry. Consumers fear making ineffective decisions or being caught out by the small-print when purchasing products[2].

With regard to intervention, the regulator could consider a traffic light approach to assess the extent to which intervention is required. This would be a dynamic concept given that products and the needs of consumers may change over time. The regulator will need to be vigilant to ensure that customers are being treated fairly and also enable the regulator to assess the type of action it needs to take at firm level. The categories would be identified as-

Green category – products that are designed to meet customer needs and sold appropriately to customers; scope for intervention is minimal.

Amber category – products that may be designed appropriately but not sold appropriately to customers; with the intention of revenue generation rather than addressing a customer need. Scope for intervention is high and needs to be done swiftly.

Red category – products that are high risk may have been designed to exploit customers. Scope for decisive action by the regulator against the firm would be urgent.

In the above three cases, the regulator cannot ignore the part played by the firm in delivering the client outcome and that the product will always be a symptom rather than a root cause of potential detriment. In the amber and red categories the regulator will need to question why the firm was acting in a manner that was against its customers' interests; in doing so the firm will be contradicting the FSA's existing rules and principles. An area of concern is how effective will the regulator be in holding firms to account when significant governance failures result in consumer detriment on a major scale. We have seen examples where a large firm was treated differently to a small firm when both appear to have serious governance failings that caused consumer detriment. Will the regulator have the courage to go beyond just financial penalties, which some large firms may view as a cost of doing business? CFA UK would suggest that to have effective regulation, firms need to be in no doubt that the costs of inappropriate behaviour significantly exceeds the benefits from undertaking such activity.

The potential for regulatory failure remains a risk

CFA UK welcomes the FSA's acknowledgement of regulatory failure and that this too is a source of risk given its limited resources. However, although we accept that the risk of consumer detriment cannot be eradicated and the consumer must bear some responsibility; regulation is the last line of defence when there is product governance failure. The regulator will need to address this key issue to ensure that it does not use lack of resources as an

[2] CFA UK response to "Simple Financial Products," can be found at
https://secure.cfauk.org/assets/2286/CFA_UK_response_HMT_simple_productsResponseFINAL.pdf

excuse not to act when there is or the potential for significant consumer detriment. The regulator cannot afford to be accused of being "asleep at the wheel." The limitation of the regulator will also be exposed when the UK is used by firms seeking to exploit regulatory arbitrage. Products may be introduced into the UK by non-UK regulated firms which the FSA may be unable to prevent. The regulator needs to do more to demonstrate the efficacy of the new approach and reducing the potential for regulatory failure. CFA UK suggests that the regulator should demonstrate how its new approach would work in practice by applying it to examples of consumer detriment that occurred before, during and after the recent crisis. Perhaps the regulator could run a series of workshops to demonstrate the efficacy of the new approach.

Conclusion

Product intervention at a firm level will be the most effective way of addressing consumer detriment. However, the regulator will need to hold firms to account in a manner that not only addresses the detriment but also sends a strong message to other firms about the consequences of inappropriate activity. Firms should be clear that the costs of such activity will outweigh the benefits by a significant margin. Product intervention at the firm level will also need to be aligned with addressing demand side issues such as education, information and consumer understanding. Better informed, capable consumers will be an essential part of enhancing market integrity and contribute to improving trust and confidence in UK financial services. Effective regulation is a public good that will make the UK an even more attractive global financial centre. Perhaps, had the regulator adopted a more interventionist approach prior to the crisis, the fallout may have been less severe. CFA UK hopes that the desire for the regulator to act more decisively will be backed up by action in the future.

Responses to questions:

Chapter 1

Q1: What issues should we consider in relation to how our product intervention approach affects equality and diversity?

No comment

Q2: How could we use our focus on products to promote equality and diversity?

No comment

Chapter 2

No questions

Chapter 3

Q3: Do you have any comments on our market failure analysis?

As stated above the market failure analysis demonstrates that the FSA has learnt from the limitations of its previous approach and the importance played by the demand side to impose market discipline. It is useful to see the regulator identify the key weaknesses why most consumers cannot impose market discipline on firms –

- consumers lack relevant information or do not use the information they do have to make appropriate purchases;

- consumers are obstructed from making accurate judgments about the price and quality of products;

- consumers do not realise there is a problem with a product they have bought until it is too late to do anything about it;

- where consumers make infrequent purchases they are less able to exert pressure on poor firms by taking their business elsewhere; and

- the problems above are exacerbated when distribution incentives are not aligned with those of consumers.

As the FSA notes in para 3.7-3.9, "our experience suggests that it can be difficult for consumers to understand and compare products and their charges…. We have previously sought to address these problems through mandated information disclosures, requiring firms to provide standardised information to consumers to help them make informed choices about whether products are suitable for their needs……. Experience has shown that consumers do not necessarily use these mandated disclosures in the way we anticipated…… However, some current product features and sales techniques are exacerbating the existing problems and can result in consumer detriment."

Much of the consumer detriment has been due to inappropriate product governance where the firms' interests were placed above those of the ultimate beneficiary. Although mentioned in chapter 2, the issue of regulatory failure is not part of the market failure analysis. Without an effective rule of law, the laws of demand and supply cannot work efficiently. The regulator cannot be expected to intervene on a timely basis in all cases, although the examples stated in the DP demonstrate that the detriment caused by regulatory failure can be just as significant as firms' exploiting the limitations of consumers being able to make informed decisions.

Q4: What do you think are the criteria by which we should judge when to intervene further?

CFA UK agrees that product features are indicators or symptoms and this should alert the regulator to undertake one of the following types of governance related interventions –

1) Firm investigation related to the governance related to the product in question;

2) Wider investigation into the firm to see if the governance is acceptable across all of its products.

3) Investigations into other firms that are involved with the design or the sale of the product causing the detriment. Experience indicates that herding is a common feature with regard to products that are selling well.

Q5: Are there any other relevant indicators that would help us identify potential problems?

There are three additional indicators that the regulator could use to identify potential problems:

- Product sales – there is a tendency for investors to chase returns whether this is the best performing asset manager of the previous year or consumers chasing high income generating deposits and products. In both cases, consumers often overlook or do not understand the risks and the benefits net of all charges. Where it is a regulated sale, the governance of the firm will be called into question. However, where consumers act without advice, the regulator needs to do more to ensure consumers are aware of the risks they are taking. As we stated in our response to the Financial Promotions Guidance consultation, often it is a challenge for customers to assess the returns generated by a fund manager after all charges and risks taken by the portfolio[3] to generate these returns. In addition, the regulator should be sensitive to firms selling a concentrated group of products and to significant amounts of switching with a view to extracting revenue rather than delivering customer benefit. The regulator has rules against churning and these need to be enforced.

- Level of complaints – The number and types of complaints received by firms and the Financial Ombudsman relating to similar products should attract the regulator's attention. Patterns in this data should alert the regulator that intervention is required and that governance may be more of an issue, while the product is a symptom of the firm's governance problem.

- Regulator awareness – the regulator demonstrated that it lacked awareness of the industry it was regulating. Banks reliant on wholesale funding, the preponderance of

[3] CFA UK's response to the Financial Promotions Guidance consultation can be found at https://secure.cfauk.org/assets/2126/CFA_UK_responseFSA_Fin_Prom_Guidance_SENT.pdf

AAA rated securities backed by inadequate assets and insurances; mortgages that were issued to those that borrowed 125% of the property value, and other signs, were largely ignored. There is a risk that unless the regulator becomes more aware of the developments within the industry, product myopia could take over and the regulator falls back into the comfort zone of addressing product features rather than product governance. It must have not escaped the regulator's notice that covenant-lite loans are becoming more prevalent and that in a low interest rate environment the hunt for yield continues to intensify.

Chapter 4

Q6: Do you have any comments on the supervisory approach we have adopted, or suggestions to help develop it?

CFA UK welcomes a more intensive supervisory approach and hopes that the supervision always has the root cause of a problem in mind rather than product alone. In addition, it is hoped that the supervisor has the confidence, resources and objectivity to take effective action where required and that the regulator is willing to address governance issues regardless of the size of the firm.

With regard to developing the approach, CFA UK would suggest running a series of workshops that demonstrate how the new approach would have addressed key areas of consumer detriment before, during and after the recent financial crisis. In addition, the regulator will also need to demonstrate that the new approach will reduce the potential for regulatory capture and failure.

Chapter 5

Q7: Should we give further consideration to new rules to prescribe conduct by firms when designing and managing products?

No new rules are required. The regulator should supervise and enforce those rules that are already in place. Consumer detriment is a governance issue at the firm level and not the product level. The recent retrospective action by the SEC against Goldman Sachs is a good example of the importance of placing clients' interests first.

As La Porta et al[4] suggest, "these laws and the quality of their enforcement by regulators and courts, are essential elements of corporate governance and finance… in contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well." On occasion, it may be more beneficial to enforce existing laws and regulations than devise new policies or as La Porta et al state "the strategy for reform is not to create an ideal set of rules and then see how well they can be enforced, but rather to enact the rules that can be enforced within the existing structure."

[4] La Porta, Rafael, Lopez de Silanes, Florencio, Shleifer, Andrei and Vishny, Robert W., "Investor Protection and Corporate Governance" (June 1999). Available at SSRN: http://ssrn.com/abstract=183908 or DOI: 10.2139/ssrn.183908

Q8: If so, what should be covered?

The regulator already has these rules and principles in place. The risk based approach has much to commend it, although the regulator must be capable, willing and able to act decisively when the risks are likely to be realized.

Q9: What would the impact be on the market?

By supervising and enforcing the existing rules and holding firms that have poor governance to account, the regulator will be able to demonstrate the effectiveness of its regulatory approach. In doing so, consumers can have more faith in the market, and those firms that place clients' interests first will feel more assured that other firms that do not place clients' interests first will be held to account. Overall, effective regulation will raise the quality of the market.

Q10: What would the implications be if we consider similar interventions for services as those discussed in this paper for products?

The key issue for consumer detriment is product governance and this relies on firms acting in the best interests of their clients rather than themselves. As we have stated, a product that is sold or created for the sole purpose of revenue generation indicates that this a symptom of a firm that does not place its customers' interests first. By intervening at the firm level, the regulator is also taking action on the services provided by the firm. The regulator regulates the financial services industry not the financial products industry.

Chapter 6

Q11: Do you have any comments on any of the possible additional interventions?

The regulator has set out the following product interventions –

- product pre-approval;
- banning products;
- banning or mandating product features (including setting minimum standards for products);
- price interventions:
- increasing the prudential requirements on providers;
- consumer and industry warnings;
- preventing non-advised sales; and
- additional competence requirements for advisers.

Product intervention is not necessary when consumers are purchasing the appropriate products for them. This requires firms and their employees involved with advising, managing and selling products to consumers to adhere to the highest level of professional and ethical standards. To ensure market integrity is enhanced, the consumer also needs to be more capable and have the awareness to make informed decisions

The regulator must not develop product myopia and intervention at the product level is not a substitute for intervention at a firm level. In fact, by encouraging firms to supply the market with a variety of products the regulator encourages innovation and also enables the regulator to become aware of some of the amber and red flags that may require attention at the firm level. Focusing at the firm level and ensuring that consumers' interests are being placed first will reduce the need to intervene in the manner set out in chapter 6 of the DP. The paradox of the regulator's product myopia is set out in para 6.44, by asking providers to have sufficient capital available to make payments to customers because the firm has made "undesirable products available." The question here is why the regulator let the firm provide these products in the first place and why were they created if there were undesirable?

Consumer and industry warnings will be more powerful where they are followed up with action by the regulator. The regulator needs to check to see if firms have taken the warnings into account and acted appropriately. Firms need to be aware of the potential consequences if they do not take heed of these warnings. Similarly, the regulator should take more decisive action when customers are purchasing products through self-direction; an example would be placing cash on deposit with institutions that offer interest rates that are considerably above those on offer elsewhere. Perhaps, the Money Advice Service (formerly known as the Consumer Financial, Education Body) could be more active here by issuing wealth warnings not too dissimilar from the weather warnings broadcast on the news.

Q12: Which activities could we define as non-mainstream advice for the purposes of developing additional qualifications?

Regulated advice should always be provided with the clients' interests in mind. Customers do not require one product, they often require a combination of financial products and it is essential that the adviser has the skills and expertise to select the right combination and make suitable recommendations that place the clients' interests first. CFA UK welcomes the RDR's aims and objectives about raising the professional standards for financial services professionals. Consumer detriment will only be reduced when financial advice is aimed at placing clients' interests first and the regulator holds those firms that do not place clients' interests first to account.

Q13: Are there any other interventions we should consider?

As stated above, the regulator needs to focus on the governance of firms rather than settle into product myopia. Intervention should be proactive, at the firm level and the costs of inappropriate activity should outweigh the benefits of the activity by a significant margin.

Q14: What would the impact of these specific interventions be on the market?

Rather than focus on the impact of specific interventions, the regulator should be focusing on how best to maximize market integrity so that the interaction between savers and borrowers is more efficient. To achieve these aims the regulator should ensure that firms are always acting in their clients' interests and those that are not are held to account. The demand side also needs to be addressed because better informed and more aware consumers are an important source of market discipline on firms.

CFA UK is aware that the DP is the catalyst to develop discussions in the area of product intervention. We trust that our comments are useful and would be pleased to meet the FSA's team to explain or to develop them further.

Yours,

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