



*CFA UK is a member society of*



Richard Lawes  
Conduct Specialists Department  
Financial Services Authority  
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London E14 5HS

11th January 2012

Dear Richard,

The Chartered Financial Analyst Society of the UK (CFA UK) welcomes the opportunity to respond to the FSA's proposed guidance on Retail Product Development and Governance – Structured Products Review, which builds on our response related to Product Intervention<sup>1</sup> and includes elements from other relevant responses to policymakers<sup>2</sup>.

This response has been prepared by the CFA UK's Professional Standards and Market Practices Committee.. The society has not surveyed its members. We make observations and cite evidence that we believe to be important and which we hope will be useful in informing the regulator when it comes to achieving its policy objectives.

#### About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 9,000 leading members of the UK investment profession most of whom work as front office investment professionals (managing portfolios, researching securities and advising on asset management). 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.

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<sup>1</sup>CFA UK response to FSA's paper on Product Intervention  
<https://secure.cfauk.org/assets/2126/CFAUKresponseProductIntervention.pdf>

<sup>2</sup> CFA UK response to FSA Guidance consultation on assessing suitability related to establishing customer risk and making a suitable investment selection  
[https://secure.cfauk.org/assets/2126/CFA\\_UK\\_response\\_FSA\\_Assessing\\_suitability\\_SENT.pdf](https://secure.cfauk.org/assets/2126/CFA_UK_response_FSA_Assessing_suitability_SENT.pdf)  
CFA UK response to Financial Promotions Guidance Consultation  
[https://secure.cfauk.org/assets/2126/CFA\\_UK\\_responseFSA\\_Fin\\_Prom\\_Guidance\\_SENT.pdf](https://secure.cfauk.org/assets/2126/CFA_UK_responseFSA_Fin_Prom_Guidance_SENT.pdf)  
CFA UK response to Financial Services Bill – call for evidence  
[https://secure.cfauk.org/assets/2481/CFA\\_UK\\_response\\_Joint\\_Committee\\_call\\_for\\_evidence\\_FINAL.pdf](https://secure.cfauk.org/assets/2481/CFA_UK_response_Joint_Committee_call_for_evidence_FINAL.pdf)

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 106,000 members in 135 countries, of whom more than 97,000 hold the Chartered Financial Analyst® (CFA®) designation.

## **CFA UK Response**

CFA UK supports what the FSA is looking to achieve through this consultation with regard to structured products, although the consultation disappoints on several levels.

### Recent history and the effectiveness of guidance

The FSA should be all too aware that this is not the first time the issue of SCARPs or Precipice Bonds has caught its attention. It appears that some firms failed to heed the concerns expressed by the regulator as far back as 2002 in relation to selling of structured capital at risk products (SCARPs) or Precipice Bonds as they were then known. As former FSA CEO John Tiner remarked in 2002 –

*"We are concerned that a product which has the risk of substantial consumer loss has largely been sold through mailings and without the benefit of personal tailored advice or a face to face meeting with a qualified adviser."*

For example in 2003, the FSA issued a guidance note that requested *"firms to improve their explanation of risk to consumers of precipice bonds and advises them to provide regular and timely information on the progress of the investment."*<sup>3</sup> This Guidance Note followed after the FSA became aware of serious cases of mis-selling related to Precipice Bonds.

Based on the most recent cases involving the new generation of Precipice Bonds, some large firms were not deterred by the fines and may not have heeded the regulators' previous concerns and Guidance. As a recent FSA enforcement action against one of the largest firms in the UK cites with regard to SCARPs<sup>4</sup> –

*"Between January 2007 and December 2009 .....during that period there were a number of serious failings in the systems and controls in respect of those sales. These included:*

- *Inadequate systems and controls in relation to assessing customers' attitudes to risk;*
- *Failing to take reasonable care to properly evidence the suitability of SCARPs for customers; and*
- *Failing to monitor staff effectively to ensure that they took reasonable care when giving advice.*

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<sup>3</sup> Guidance Note 7 (2003) – No longer in effect  
<http://www.fsa.gov.uk/pubs/guidance/guidance7.pdf>

<sup>4</sup> <http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/087.shtml>

- *Concerns were identified by the FSA during a supervisory visit to the firm, which subsequently led to the FSA commencing its enforcement investigation*

*These failings amounted to a breach of Principle 3. As a result, customers were exposed to an unacceptable risk of being sold a SCARP that was unsuitable for them."*

Fortunately, the large firm that was fined in 2011 is reported to have improved its systems and controls.

#### Willingness to take regulatory risks

While it is welcome to see some firms engaging in good practices, based on the fines levied by the FSA on some large firms, it appears that they were willing to run regulatory risks in placing their interests above their customers with regard to a variety of products and not just those with embedded derivatives<sup>5</sup>. However, it is unclear whether or not the fines imposed on firms exceed the profit generated by the sale of the products and whether or not the clients of the firm received any further compensation. If a firm is fined less than it generates from such activities then a fine becomes purely an additional cost of doing business. This must not be the case, even after taking account of the discount that the FSA may offer for early settlement. This is an area where CFA UK has a major concern and perhaps the FSA should be transparent and set out how the costs of inappropriate behaviour is exceeding the benefits from such activity.

The enforcement action above relates to a large firm that was willing to run regulatory risks and this raises the issue of whether or not the enforcement action is a credible deterrent to others that are currently or considering running similar regulatory risks. The key to raising trust and confidence and improve the integrity of the market for financial services rests on effective supervision of the rules and a credible threat of enforcement. Guidance, as history has shown has been ineffective.

#### Product Governance is key: this guidance is premature

It is commendable that the current consultation recognises the importance of Product Governance, which is integral to the Treat Customers Fairly (TCF) initiative; CFA UK considers product governance the key determinant on whether or not a product is sold appropriately. However, the consultation disappoints as it does *"not assess sales processes or the quality/suitability of individual sales, nor does it include distributors in the review. The FSA will be doing further work on these issues in 2012."* It would have been preferable to undertake a review of the complete process from product creation, development to post sale. In our opinion this is the approach needed for the FSA to decide what actions are needed. CFA UK would suggest that guidance is probably the least effective course of action at this stage.

Any firm acting in its clients' interests would not require this guidance. Similarly, the FSA's consideration to issue further rules underlines our fears that more effective supervision and enforcement of the existing requirements is not being considered.

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<sup>5</sup>" FSA- Top 10 Fines of 2011," Money Marketing,30 December 2011

<http://www.moneymarketing.co.uk/1043590.article?cmpid=MME01&cmptype=newsletter&email=true>

## Product myopia still dominates the FSA's approach

The current guidance consultation focuses on the product development chain with a view to earlier intervention. This again disappoints us as it highlights the concerns we raised in our response to Product Intervention, namely that product myopia dominates instead of product governance. In almost all cases of consumer detriment it is rarely the product that is the issue; rather, it is the inappropriate selling of the product. This has been made clear not only in recent FSA fines levied on large firms but also historically as well. The recent crisis highlighted the extent to which some senior management and advisers at regulated firms were willing to take regulatory risks yet, despite the FSA's own findings, very few have been brought to account. It is surprising that the consultation does not cite COBS rule 2.1.(1) (client's best interests rule) <sup>6</sup>

*"A firm must act honestly, fairly and professionally in accordance with the best interests of its client (the client's best interests rule)."*

The broader point being that by overemphasising the product design the FSA overlooks the importance of product governance and the people responsible for implementing it appropriately.

While we agree that any product that has been developed should undergo a thorough due diligence process, it is equally if not more important to ensure that the product is sold appropriately. Products that have embedded derivatives may not be suitable for all consumers, and those consumers that they are suited to should have the reassurance of knowing that they will be advised appropriately. This places the onus on firms and their customer facing employees to ensure that the appropriate checks and balances are in place so that risks the customer takes are the ones they are willing to take. Rule 2.1 (1) is not ambiguous and firms that do not comply with this rule should face the consequences.

## Supply-side myopia

CFA UK has regularly emphasised that policymakers and standard setters should have a more balanced approach and consider ways to enhance the demand side of the financial services market. Given some firms (regardless of size) are willing to run regulatory risks, having more capable consumers will enable the market to work more effectively.

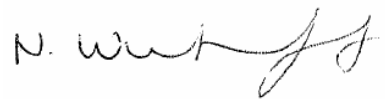
In light of the FSA's own experiences and the need to improve trust and confidence in the market for UK financial services, CFA UK recommends that the FSA take a more proactive approach that focuses on product governance rather than product myopia. Working to make the demand side a more effective source of market discipline would also be a constructive step and would reduce the overemphasis on the supply side of current regulatory initiatives. At this stage the guidance is not timely given that the review has not been completed and there are still cases of firms willing to take regulatory risks with a variety of products.

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<sup>6</sup> Conduct of Business Sourcebook  
<http://fsahandbook.info/FSA/html/handbook/COBS/2/1>

We hope that the CFA UK's response is helpful to the FSA and we would be open to further discussions with the financial regulator about any of the points we have raised.

Yours,



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