Conduct Regulation of Retail Financial Services – A supervisory assault on traditional business models

The FSA published its *Retail Conduct Risk Outlook 2011* at the end of February 2011. This document presented the FSA’s view of “…current, emerging and potential risks to consumers arising from poor conduct by firms. The outlook aims to inform a dialogue with consumers and firms, increase awareness of risks, and inform our own supervisory focus.”

The Retail Conduct Risk Outlook refers to the launch in March 2010 of the FSA’s “Enhanced Consumer Protection Strategy”, and we understand that this strategy will continue to be pursued with vigour when responsibility for regulation of conduct matters transfers to the Financial Conduct Authority in 2013. The enhanced strategy has three objectives:

- improving the "long-term efficiency and fairness of the market"
- *intensive supervision* of firms: ensuring that firms treat their customers fairly, with earlier intervention in the development of retail products, based on "sound business-model analysis and integrated firm-risk assessment"
- "credible deterrence" through tough enforcement action where a regulatory failure is identified.

In respect of the second objective, it is worth re-quoting the comments that Hector Sants, the CEO of the FSA, made in a speech given in March 2010 on the “…issue of culture and behaviour – dare I say it, ethics? Poor risk management was a key driver of the crisis… my personal view is that if we really wish to learn lessons from the past, we need to change not just the regulatory rules and supervisory approach, but also the culture and attitudes of … the management of major financial firms”.

It is now clear that the FSA is focusing not only on the outcomes produced by financial products (and on unfair outcomes in particular), but also on all other stages in the lifecycle of retail products, from design and implementation to sales and after-sales activity. Firms would be well-advised to prepare for this more holistic approach to consumer protection in the retail markets. It is likely to manifest itself in the form of a much greater level of regulatory intervention, not just in the development and distribution of new and existing products, but also at a strategic level. What we may be beginning to see is the regulation of business models through the medium of product regulation.

Firms operating in the retail markets can and should take steps to adapt to this new approach. In so doing, senior management will need to recognise and re-evaluate the legal and regulatory risks that arise in their businesses. Certain fundamental legal risks have in the past been overlooked; such practices may now be more readily

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1 Hector Sants, Annual Lubbock Lecture in Management Studies, 12 March 2010.
identified and pursued by an enforcement-led regulator (see, for example, our March 2010 Briefing Paper on Conlicts of Interest).

1. INTERVENTIONIST TRENDS EVOLVE

Since the announcement of the FSA’s Consumer Protection Strategy, there have been some major regulatory initiatives which will inevitably frame and influence that strategy in the longer term.

1.1 New UK financial regulators

The Government’s policy to divide regulation of financial firms between a “prudential” and a “conduct” regulator has been confirmed. The Government’s second consultation document on this subject provides considerable detail on the proposals (see our Briefing Paper on that topic of February 2011).

The consultation document confirms that the new conduct regulator, the Financial Conduct Authority (FCA), will continue the FSA’s Consumer Protection Strategy: “…proactively intervening in a product’s lifecycle with greater scrutiny of firms’ design and product governance complementing the traditional focus on sales and marketing, and the disclosure of information”.

1.2 Express powers for product intervention

The Government has stated that the FCA is to be given powers to “intervene to block an imminent product launch or to stop an existing product from achieving volume sales…”.

This proposal echoes a similar proposal made by the EU Commission in its Review of the Markets in Financial Instruments Directive (MiFID), published in December 2010. The Commission proposes in that document that it should have power to ban investment services and activities where “services are provided in a way which gives rise to significant and sustained investor protection concerns”.

In January 2011 the FSA, doubtless anticipating the proposed new powers for the FCA, published a Discussion Paper entitled Product Interventions (DP11/01), canvassing a range of potential intervention tools, including product pre-approval and banning orders.

Although there is less clarity around the Commission’s MiFID proposals, it is clear from the FSA’s Discussion Paper and the Government’s regulatory reform consultation that the FCA will have power to ban products pre-emptively, before they are sold, on the basis that consumer detriment may occur. This is likely to involve the regulator passing judgement not just on particular product features, but also on matters which are at the core of a firm’s business, from its senior management culture down to the training, supervision and incentivisation of customer-facing staff.

2. RETAIL CONDUCT RISK OUTLOOK – IS PROFITABILITY COMPATIBLE WITH COMPLIANCE?

Against this background of a new, intensive and more interventionist approach to supervision, the FSA’s Risk Outlook makes for instructive reading. In this paper we do not discuss all of the risks to retail markets which the FSA has identifi ed in that document, but rather we highlight below the risks that appear to be exercising the greatest influence over the development of FSA policy in the area of retail conduct of business. The FSA has identified risks in three broad categories:

- current issues: for example, treatment of mortgage customers and payment protection insurance
• **emerging risks**: for example, strategies to comply with the new rules on adviser charging coming into force at the end of 2012, and remuneration policies and practices

• **potential concerns**: these are defined as "risks that ... are already present at an early stage of development, or risks that we might expect to develop given our assessment of how firms and consumers may respond to the environment".

The FSA's assessment of the third category of potential risks sets the scene for likely intrusive monitoring of, and possibly intervention in, firms' business models and governance.

### 2.1 The economic and prudential environment

The FSA's assessment recognises that there is a combination of factors affecting the current profitability of retail firms:

- the implementation of new prudential requirements, requiring firms to hold more and better quality capital
- low prevailing interest rates, affecting, in particular, the profitability of mortgage business
- the withdrawal or decline of some significant income-generating products, such as payment protection insurance.

The FSA foresees that risk of consumer detriment may well arise from a firm's need to sustain or increase profitability against this background. Although examples of potential problem areas are given (expansion of wealth management or "quasi-wealth" management services; product bundling; new structured products), there is a pervasive theme. In the pursuit of profitability, the FSA takes the view that firms may be inclined to act in a way which is contrary to the interests of their customers.

### 3. UNDERSTANDING AND CONTROLLING REGULATORY RISKS

In simple terms, there are three ways in which a firm may attract regulatory intervention which could prove both intrusive and disruptive to its business:

- a failure of systems and controls (for example, failures in the training and supervision of sales forces)
- a failure to understand and apply the legal and regulatory duties which govern an activity (for example, the rules on inducements or conflicts of interest)
- a failure of senior management to strike the right balance between duties to shareholders and duties to customers, leading to inappropriate cultures and business targets.

Clearly, these factors often overlap; but equally represent independent sources of risk.

In our comments below we address, in particular, the last two factors.

### 3.1 Senior management duties: shareholders or customers?

Leaving aside certain refinements imposed by company law, the traditional duty of the senior management of a firm is to deliver "shareholder value" – a concept which many, if not most, senior managers translate into the even
more succinct notion of profitability. Management has every excuse for this: it is how their performance is judged by their shareholders and the market as a whole.

On this overly-simplistic model, senior management seeks to sustain and increase profitability by selling products and services and the demands of regulatory compliance have in many firms, been viewed as impediments to be negotiated. History has shown that in respect of certain product types insufficient attention has been paid by management to long-term risks inherent in product design or to the suitability of products for their target customers.

There is a widespread perception that law and regulation in the financial services area operate as a series of brakes on the profitable progress of a firm, which it is the duty of management to avoid or mitigate. Regulators have now started to challenge this notion in a sustained way.

Where law and regulation impose positive duties on firms, however, these duties can change not only the environment in which the firm operates, but the nature of the firm itself. To take a very simple example: a firm which is a discretionary investment manager, and is therefore likely to owe fiduciary duties to a particular customer or set of customers, must be managed as a fiduciary, rather than simply as an investment business which happens to be subject to those duties. Similarly, firms which are now subject to more onerous positive regulatory obligations in the retail area of product development and marketing must ensure that those obligations are embedded in management’s culture and approach, rather than being regarded as mere minimum standard which are externally imposed. The legal and regulatory risks that flow from a failure to appreciate this consequence are becoming more serious and now have the capacity fundamentally to threaten the viability of business models.

3.2 Failure to appreciate regulatory or fiduciary duties; “market practice” a false benchmark

It is therefore critical that managers have a good understanding not just of their firms’ “headline” regulatory and legal responsibilities, but also of the detail and practical implications of those responsibilities: firms should not leave those responsibilities to be articulated solely in internal compliance policy documents that are left largely unread (the FSA was scathing about this practice in its 2009 review of MiFID compliance).

We commented on developments in these areas in our March 2010 Briefing Paper on Conflicts of Interest and in our June 2010 Briefing Paper on Regulatory challenge to market norms. In particular, we noted the FSA’s increasing concerns around:

- conflict policies, which were “too high level and did not seem to be reflected in practical systems and controls”, and
- senior management engagement with Treating Customers Fairly issues, especially “in terms of driving change throughout the business”.

In addition, our previous papers explained that a firm’s fiduciary duties co-existed alongside regulatory obligations and could impose higher standards – for example, in respect of:

- the charges levied on customers, and
- the direct or indirect benefits which a firm might gain from customers’ business without either accounting to the customer or obtaining his or her express consent.
We stressed a further point: in the past, firms have often refrained from doing anything about these matters on the ground that to do so would be out of line with “market practice”. This was historically seen as a comforting shield and justification to continue with a particular business model. However, recent enforcement action by the FSA has substantially undermined the “market practice” defence and the FCA will have powers that are directed at halting market practices which it perceives to be damaging to consumers.

4. THE REGULATOR’S MUSIC HAS NOT STOPPED

As of March 2011, the determination of regulators and the criticisms they voice are intensifying.

Hector Sants has said of the approach to be adopted by the FCA that:

“[the FCA’s] approach will be based on the premise that the degree of consumer detriment seen over the last decade has been at an unacceptable level to society and a more interventionist style of regulation is justified”,

and, further:

“it is thus inevitable that a conduct regime will lean more towards rules than principles as this is a necessary consequence of its focussed objectives. This however, should not be seen as undermining the need for firms themselves to have a strong cultural framework which encourages employees to behave in a principled manner”.

In keeping with this general theme is the increasing number of rulebook developments which seek to change traditional business models, such as the Retail Distribution Review and the proposals for the with-profits insurance industry published in the FSA’s Consultation Paper 11/05 (February 2011). The FSA has concluded that there are long-standing weaknesses in the safeguards for with-profits policyholders and structural failures in firms’ corporate governance. The FSA’s response is, in effect, to seek to dismantle much of the edifice of the sector and to rebuild it according to the FSA’s own specifications.

It is also important not to overlook the Governor of the Bank of England’s recent comments in the Daily Telegraph:

“[Too many in financial services have thought that, if it] is possible to make money out of gullible or unsuspecting customers, particularly institutional customers, that is perfectly acceptable”.

The Governor will, of course, have a central role in the prudential supervision of firms under the Government’s proposed new structure for UK financial regulation.

5. AN APPROACH FOR FIRMS TO TAKE – LOOKING THROUGH THE REGULATOR’S EYES

Firms would be well-advised to respond to the developing regulatory agenda by anticipating (if not in all respects accepting) the regulator’s perspective in an examination of their cultures and practices.

The aim of this exercise would be to identify weaknesses and gaps before they are exposed by “intrusive” supervision, and to remove, strengthen or fill them. The over-arching principle should be not solely to establish whether customers are treated “fairly” (in the sense of being not unreasonably served by a firm’s products or services) but also to establish that the firm is complying with its regulatory and legal responsibilities, based on what Hector Sants has described as “more rigorous analysis and challenges to business model decisions”. 
This means, among other things, that firms must have a good understanding of their regulatory and legal responsibilities, not just at a theoretical level but also at the business level. Firms that have operations in multiple jurisdictions should understand how these responsibilities differ between those jurisdictions.

5.1 Product development
A responsible, customer-focused process for developing new products might involve:

- careful identification of the target market(s) for which the product might be suitable in generic terms (having regard to the regulatory meaning of "suitability")
- conversely, careful identification of market segments (including sub-segments of the target market(s)), for which the product might be unsuitable in generic terms
- due diligence on the risks, including risks over the likely product lifetime, associated with the product
- analyses of what could go wrong with the product for the customer and how that risk will be mitigated and monitored
- high standards of product description and risk disclosure
- high standards of training and monitoring of customer advisers
- avoiding such pitfalls as:
  - responding to sluggish sales by lowering the due diligence standards applied to product information, or
  - relying on out of date information and training materials where a product replaces a similar product but where differences are material
- continuous monitoring of the quality of sales.

5.2 Risks and liabilities in customer relationships
Firms should adopt the same rigorous approach to their relations with customers more generally, especially in the critical areas of investment advice and investment management.

The obvious regulatory benchmarks are:

- the client’s best interests rule (COBS 2.1.1R), which requires a firm to act in accordance with the best interests of its client at all times in respect of retail investment business clients and, in respect of professional clients as well where business falls within the scope of MiFID
- the suitability rules (COBS 9), in respect of advisory and discretionary clients, and
- the dealing and allocation rules.
In addition, firms should have regard to possible duties and liabilities arising under the general law, especially fiduciary duties. Fiduciary duties are particularly relevant to:

- **conflict management**, between a client's interest and a firm's interest, or between the competing interests of clients. A breach of duty could arise at the most basic level – for example, where a firm is an investment adviser (and therefore likely to be a fiduciary) but where advice is more motivated by the potential for the firm to make money than by the best interests of the client, and

- **undisclosed benefits**, where a firm receives undisclosed financial benefits from a customer relationship – for which a fiduciary must strictly account to its client, leaving aside acceptable regulatory requirements. An example would be an investment manager taking profits which arise from dealing errors when managing a portfolio (e.g. when correcting dealings which breach a mandate parameter).

### 6. CONCLUSION

For the foreseeable future, financial institutions will have to live with a considerable degree of regulatory distrust of much of their activity, a distrust which is unlikely to be mitigated by any significant increase in political or popular support for the financial services industry.

Compliance with rules and changes in management culture will be closely monitored and enforced. However, in any rigorous and honest analysis of the duties which a firm owes to its customers, especially its retail customers, senior management may find that their objectives should be more closely aligned with those articulated by regulators. The long term health of their firms will depend on changing governance and culture, and driving that change into the product manufacturing, selling and problem solving processes that they operate.

Regulated firms may need to consider whether current resources, particularly in legal and compliance functions, are sufficient and whether those functions have sufficient authority and status to provide management with the support they will inevitably need to address these challenges.