Providers and distributors

The Financial Services Authority (FSA) recently published guidance on The responsibilities of providers and distributors of products and services for the fair treatment of customers (PS07/11). This follows consultation on Discussion Paper (DP) 06/4 published last September, which has the same title. It should also be seen against the backdrop of the FSA’s retail distribution review, which has generated a number of other papers and initiatives, including DP07/1 (A review of retail distribution), DP07/2 (Platforms: the role of wraps and fund supermarkets) and an occasional paper published in July entitled Treating customers fairly (TCF) in product design. The FSA has indicated that it may revisit the guidance in due course in the light of these papers. Meanwhile, industry trade associations countered with a set of principles, also published in July 2007, entitled Retail structured products: principles for managing the provider-distributor relationship.

Status of the guidance

The guidance is now cast as formal guidance under section 157 of the Financial Services and Markets Act 2000 (FSMA). This seems to have been a response to queries about the status of the guidance as originally proposed and FSA guidance in the context of principles-based supervision more generally. The FSA has decided not to hold a further consultation before finalising the guidance, taking the view that industry consultation has already been extensive. The guidance will not become part of the Handbook and the FSA’s stated view is that it does not alter any Principles or replace any rules or guidance: ‘Rather it articulates existing responsibilities in the Principles, detailed rules and guidance, in FSMA and subordinate legislation, and case law’.

Principles-based supervision and changes from the draft statement in DP06/4

The FSA has concluded that there was a broad consensus as to the description of the respective responsibilities of product providers and distributors in the draft statement in DP06/4 and that any concerns stemmed not from a substantive disagreement but an ‘over-interpretation’ of what is needed. Nonetheless, the revised statement is significantly more high-level than the original, which has meant that some of the more sector-specific material has gone, including the case studies published with the original draft. While the move towards higher-level guidance could result in uncertainty, it helps to avoid inappropriate prescription in one sector as a result of written guidance principally intended for another. The FSA has left open the possibility of issuing further guidance in specific areas in due course or blessing industry-specific approaches developed by trade associations with their members. This could help provide greater certainty.

Extensive reliance on the Principles means that the guidance is one of the clearest examples yet of the FSA’s intention to move towards principles-based supervision.
The guidance is framed throughout as a commentary on the application of certain of the FSA’s Principles, in particular:

- Principle 2 – firms to conduct business with due skill, care and diligence;
- Principle 3 – firms to control affairs responsibly and effectively with adequate risk management;
- Principle 6 – firms to pay due regard to interests of customers and treat them fairly; and
- Principle 7 – firms to pay due regard to information needs of clients and communicate information in a way that is clear, fair and not misleading.

**Overview of the guidance**

The guidance breaks down into two parts, one directed at ‘product providers’ and the other at ‘distributors’. Consistent with its recognition of the need to avoid a ‘one size fits all’ approach, the FSA has emphasised that it intends these terms to be understood in a loose sense as describing two elements in the process whereby a financial product is created and sold to a consumer and that firms will not necessarily fall neatly into one category or the other; ‘responsibilities flow from the actual roles or functions undertaken by the firm’ and ‘in considering which responsibilities apply to it, a firm should consider the functions and roles it undertakes in the product life-cycle’.

The FSA has also retained the concept of a ‘pure manufacturer’, which creates components that are subsumed into retail products with or without its knowledge. The position of a pure manufacturer is discussed separately from that of a product provider and the FSA describes its duties as largely based on Principle 2 and Principle 7. The level of skill, care and diligence due is to be determined taking all the circumstances into account: ‘These may include the manufacturer’s knowledge of whether a product or service is provided to a firm, rather than an underlying customer, and the information needs of the firm. In addition, the pure manufacturer will normally be obliged to communicate information to the retail manufacturer in a way that is not misleading’. No surprises there.

**Product providers**

The duties of product providers more generally are described by reference to five elements in the production/distribution process and, in each case, the FSA identifies the Principles it considers most relevant.

- Undertaking product or service design – Principles 2, 3 and 6 (the FSA indicates, among other things, that providers should identify the types of customer for whom a product is likely to be suitable/unsuitable).
- Providing information to distributors – Principle 2 (the FSA indicates, among other things, that there is a need to consider by reference to the type of distribution channel and distributor whether information will enable distributors to understand the product sufficiently to give suitable advice and to extract any relevant information and communicate it to the end customer).
- Where applicable, providing information to customers – Principles 3, 6 and 7.
- When selecting distribution channels – Principles 2, 6 and 7 (the FSA indicates a need to consider whether a product is one on which customers would be wise to take advice and to review whether what is happening in practice corresponds to what was originally anticipated).
- Post-sale responsibility – Principles 2, 6 and 7.

Even where the provider does not have a direct relationship with a retail customer, the FSA expects it to consider its regulatory duties to distributors/retail product manufacturers.

A key concern for the FSA has been the interface between providers and distributors and, as part of that, the quality of information made available by providers. The FSA is clear that both providers and distributors have responsibilities in this respect. However, the guidance on the duties of distributors is helpful to product providers in making clear that:

- in passing on a promotion created by a provider, distributors must act with due skill, care and diligence;
- a distributor passing provider materials to customers should consider whether it understands them;
Providers and distributors should ask providers for more information/training if that seems necessary to understand the product; and distributors should consider the fit of the provider’s product with the customer’s needs/risk appetite.

Distributors
The guidance will also be relevant to the activities of private wealth management. As with product providers, the guidance for distributors is broken down by reference to elements in the distribution process and the associated Principles that the FSA considers the most relevant.

- Financial promotions – Principles 3, 6 and 7.
- Provision of information to a customer at or before the point of sale – Principles 2, 6 and 7.
- Advising on the selection of a provider – Principles 2 and 6.
- Post-sale responsibility – Principles 3 and 6.

The international dimension
One of the concerns with the first draft of the FSA’s guidance was the risk that it might put UK regulated firms at a competitive disadvantage internationally by imposing higher standards than those applying to providers and distributors in other jurisdictions. This could be a particular issue where they are operating under a cross-border services passport in competition with firms elsewhere in the European Economic Area, as UK conduct of business regulation would apply in this case. Whether this anxiety is justified remains to be seen and the less prescriptive approach taken in the revised guidance may be helpful. However, the FSA’s view that ‘the Guide only applies to the same extent as the Principles and therefore only has impact on international competitiveness to the same extent as the Principles’ seems somewhat naïve.

Compliance
It is well understood that the move towards principles-based supervision requires a fundamental reorientation of risk and compliance culture with a move away from reliance on complying with detailed rules towards a considered assessment of how best to achieve regulatory outcomes set by the Principles. More sophisticated operators have already tended to take a broader approach to assessing risk and responsibilities, in parallel with a more rules-based compliance. However, the emergence of such an overtly principles-based approach from the FSA will inevitably lead firms to revisit this. The initiative has also already given an important stimulus to the development of an ‘interpretive community’ of firms, industry associations and advisers seeking greater certainty by building consensus around what standards are acceptable in seeking to operate within the guidance. This process is likely to continue and it will be important to engage with it.

Trade association principles
Also in July 2007, a paper entitled Retail Structured Products: Principles for managing the provider-distributor relationship was published jointly by the European Securitisation Forum, the International Capital Markets Association, the International Swaps and Derivatives Association, the London Investment Banking Association and the Securities Industry and Financial Markets Association.

There are 10 Principles, regarding: (i) the use of distributors; (ii) Chinese walls; (iii) product approval; (iv) suitability and confidentiality; (v) distributors’ understanding; (vi) promotional materials and information; (vii) ‘know your distributor’; (viii) ‘know your provider’; (ix) legal risk; and (x) clarification of roles.

The intended role of the Principles has a couple of distinctive features. First, they are not binding. ‘It should be noted that the Principles are non-binding and, as such, intended purely to help inform firms’ thinking.’ There are some parallels between this and the role of the FSA Guidance: in both cases, the definition of the specific steps required to meet firms’ responsibilities in particular situations is left to firms. Second, the Principles are global and not national. ‘The Principles are intended to be sufficiently broad in their applicability to provide a reference framework for managing the provider-distributor relationship in retail structured products markets globally... The Principles are drafted with no single jurisdiction in mind; they are, on the contrary, intended for global use, at a high level.’
As one might expect, the Principles broadly are consistent with the Guidance, both in their general terms and in their provision that ‘no party takes on the regulatory obligations of another or the oversight of that other party’s compliance with those obligations’. In PS07/11, the FSA welcomes trade association initiatives, but comments that ‘…we do not think that industry action alone will lead to the change in firms’ behaviour that we think is needed in this area… We do, however, view our work as complementary to trade association efforts…’. Thus, the Principles provide both a platform for increased international regulatory harmonisation, and a further dimension of guidance for UK regulated firms.

Common law developments

A number of recent English judicial decisions, relating both to tortious liability for pure economic loss and statutory misrepresentation, are relevant to the responsibilities and duties of providers and distributors.

Riyad Bank v Ahli (2005, 2006)

In this case a United Bank of Kuwait (UBK), which later changed its name to Ahli, successfully operated a Sharia fund. It entered into a white label arrangement with a Riyad Bank entity (Riyad), whereby Riyad would: offer a new Sharia fund to its clients; structure and operate the new fund as a mirror image of the existing UBK fund; act as adviser to the fund; and engage UBK as technical adviser to itself. Riyad had no relevant expertise and was entirely reliant on the expertise of UBK in structuring and operating the fund. Prospective investments for the fund were negligently valued by UBK, and the fund failed. The fund sued UBK for negligence. Even though the contractual arrangements had been structured to avoid a direct contractual link between UBK and the fund, and even though the documentation attempted to exclude any direct duty to the fund, UBK was held to have assumed tortious responsibility to the fund. It therefore owed a duty of care and was liable. The key factual basis for this decision was the lack of Riyad’s expertise.

There are lessons for the provider. A direct tortious duty of care in favour of investors may arise where, in operational reality, the distributor lacks necessary expertise regarding the product, whether to judge suitability or provide continuing services. To avoid such a duty of care arising, the provider should consider conferring relevant expertise on the distributor, ensuring in particular that it understands the nature of the product and the risks associated with it.

Seymour v Ockwell (2005)

This case related to an insurance bond that served as a wrapper for a private offshore fund, which in turn invested in ‘no win no fee’ ambulance-chasing litigation. This high risk investment was sold to a retired couple for whom it was unsuitable. The product provider wrongly advised the independent financial adviser (IFA) that the product was low risk. Relying on this advice, the IFA wrongly advised the investors. After making the investment and during the cooling off period, the investors became concerned and queried the level of risk. The IFA reassured them. The fund collapsed and the investors sued both the IFA and the product provider. Their claim against the product provider was rejected on the basis that there had been no assumption of responsibility; the claim against the IFA succeeded, as it was no defence that the IFA had been wrongly advised in turn; and the product provider was held liable to the IFA for contributory negligence.

The key practical lesson of the decision for distributors is that it is unsafe to rely wholly on the advice of the provider to assess suitability; an independent judgement must be formed.

The key lessons for providers are that, even if no direct duty of care to the investor arises at common law, there may still be exposure to tortious liability through the doctrine of contributory negligence, and also the need for care regarding the understanding of its own staff and also that of the distributor. Of course this accords with the provider’s regulatory responsibilities.

Peekay v ANZ (2006)

This case involved an action for statutory misrepresentation by an investor against a distributor, regarding a structured deposit that referenced Russian GKOIs. The account executive at the distributor did not understand the product and believed that it conferred a
proprietary, as opposed to a synthetic, position in GKOs. On the basis of her comments, the investor formed the same misapprehension. Before making the investment, the investor received the product documentation, which described the product correctly and contained a risk warning that the client was required to sign, confirming that it understood the risks. The investor’s representative did not read this documentation because he assumed that he would have been told if it differed from the comments already made to him. He signed the documentation and returned it.

The Russian government defaulted on GKOs and the investment became virtually worthless. The investor sued on the basis that it had relied on the misrepresentation of the distributor and had believed that it had a proprietary position that would enable it to negotiate with the issuer in the event of default.

The claim succeeded at first instance but was rejected in the Court of Appeal. This was on the basis that the investor had made the investment not in reliance on the misrepresentation of the distributor but on his false assumption that any discrepancy between the representation and the documentation would have been brought to its attention; he should have read the documentation. It was also argued that the signing of the risk warning prevented the investor from arguing that it did not understand the risks.

Practical lessons for the distributor from the decision include: the importance of ensuring that staff dealing with investors understand the product; the importance of product documentation and documentation procedures; and the particular importance of signed risk warnings. However, a crucial feature of the decision was the non-retail status of the investor: Peekay was an offshore investment vehicle. The courts are highly unlikely to take a similarly robust approach to claims from retail investors.

The question of product provider liability was not raised in the decision. However, there may be similar, albeit indirect lessons, including: the importance of ensuring that staff dealing with the distributor understand the product; the importance of effective documentation and documentation procedures, including risk warnings signed by the product provider; the importance of requiring the distributor to provide effective documentation; and documentation procedures, including risk warnings signed by the investor.

General conclusions

The responsibilities of providers and distributors regarding retail structured products are being defined by an interaction of regulatory, common law and soft law provisions. Although the position is complex and dynamic, certain simple conclusions can be drawn at this stage.

Principles-based regulation

Just as the FSA’s exercise of its regulatory powers is increasingly based less on detailed rules and more on general principles, so the judges’ decision-making is based less on doctrinal detail and more on a pragmatic assessment of the relevant facts as a whole. Each is less constrained than before by detailed rules in seeking to achieve, respectively, the fair treatment of customers and a just outcome. Regarding retail products, the best approach for providers is to focus less on detailed rules and contractual provisions and more on the factual detail of the arrangements, and whether outcomes are fair to investors and meet their reasonable expectations as created by the firm.

Responsibilities of providers to investors

The Guide provides for regulatory responsibility for providers towards the distributor’s investing clients. Case law is developing functionally equivalent common law liability, whether directly or through the doctrine of contributory negligence. Both the FSA and the trade associations acknowledge the roles of the provider and distributor in defining their respective responsibilities. But agreement between them does not contractually bind investors who are not party to it and may not prevent the assumption of responsibility at common law, and hence a duty of care, which, as mentioned above, is assessed objectively and may turn on awareness of reliance in practice. Providers may not be able realistically to exclude such responsibilities and should focus instead on discharging them.