

PRODUCT GOVERNANCE

Strategic context and collective impact

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Joint Associations Committee
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Overview

- **Product governance**
 - Origination of regime
 - Key elements and issues
 - Overlap with other regulatory regimes
- **Unfair contract terms**
 - Current regulatory regime
 - Key issues for structured products
- **PRIIPs, product governance & unfair contract terms**
 - Key cross-overs and implementation considerations

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Product governance

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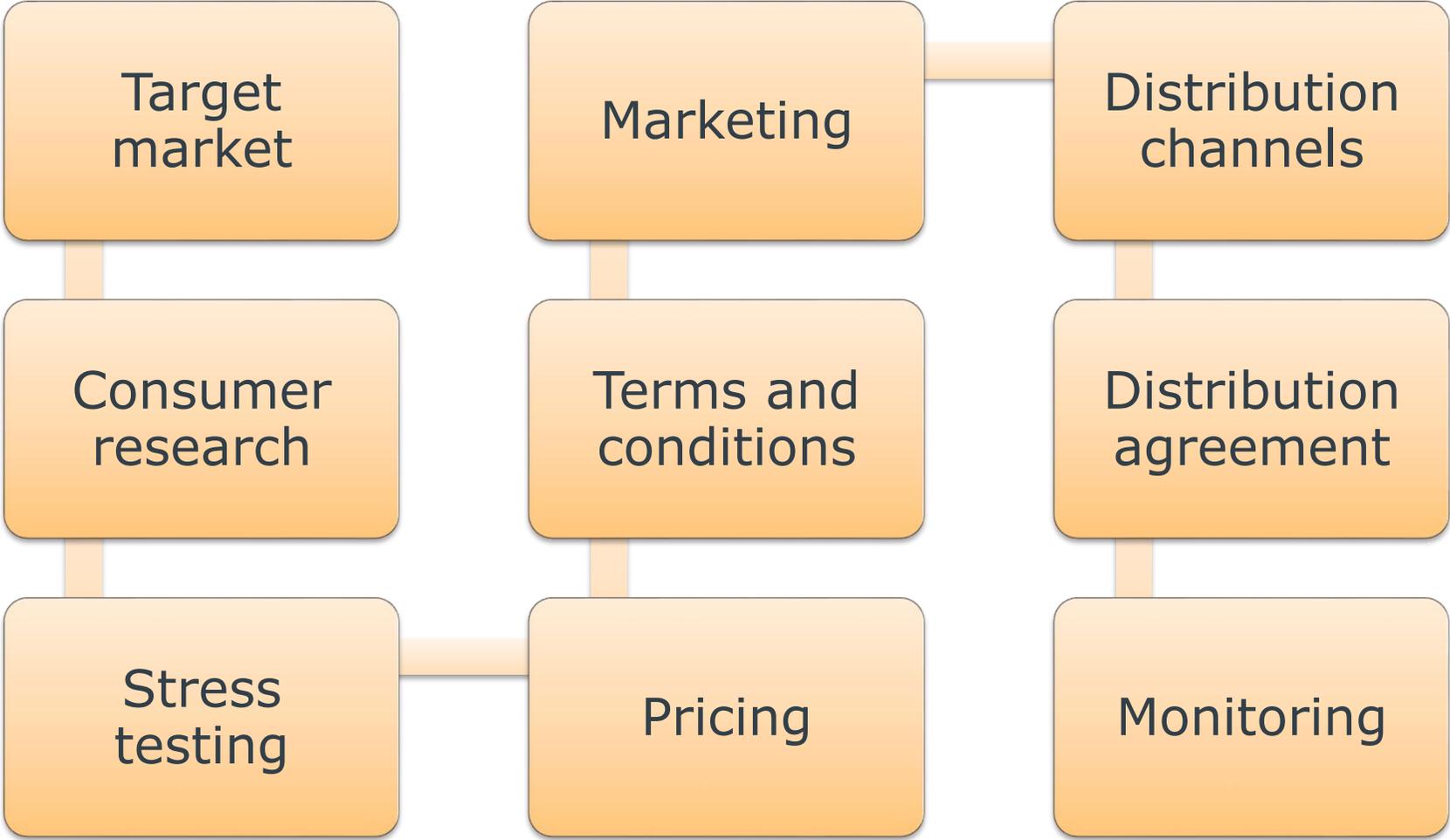
ORIGINATION OF REGIME

- **UK**
 - FCA Principles for Business and guidance
 - Retail clients
 - Structured products
 - Manufacturers only
 - In force

- **Europe**
 - MiFID II
 - Professional clients and retail clients
 - All MiFID financial instruments
 - Manufacturers & distributors
 - 3 January 2018

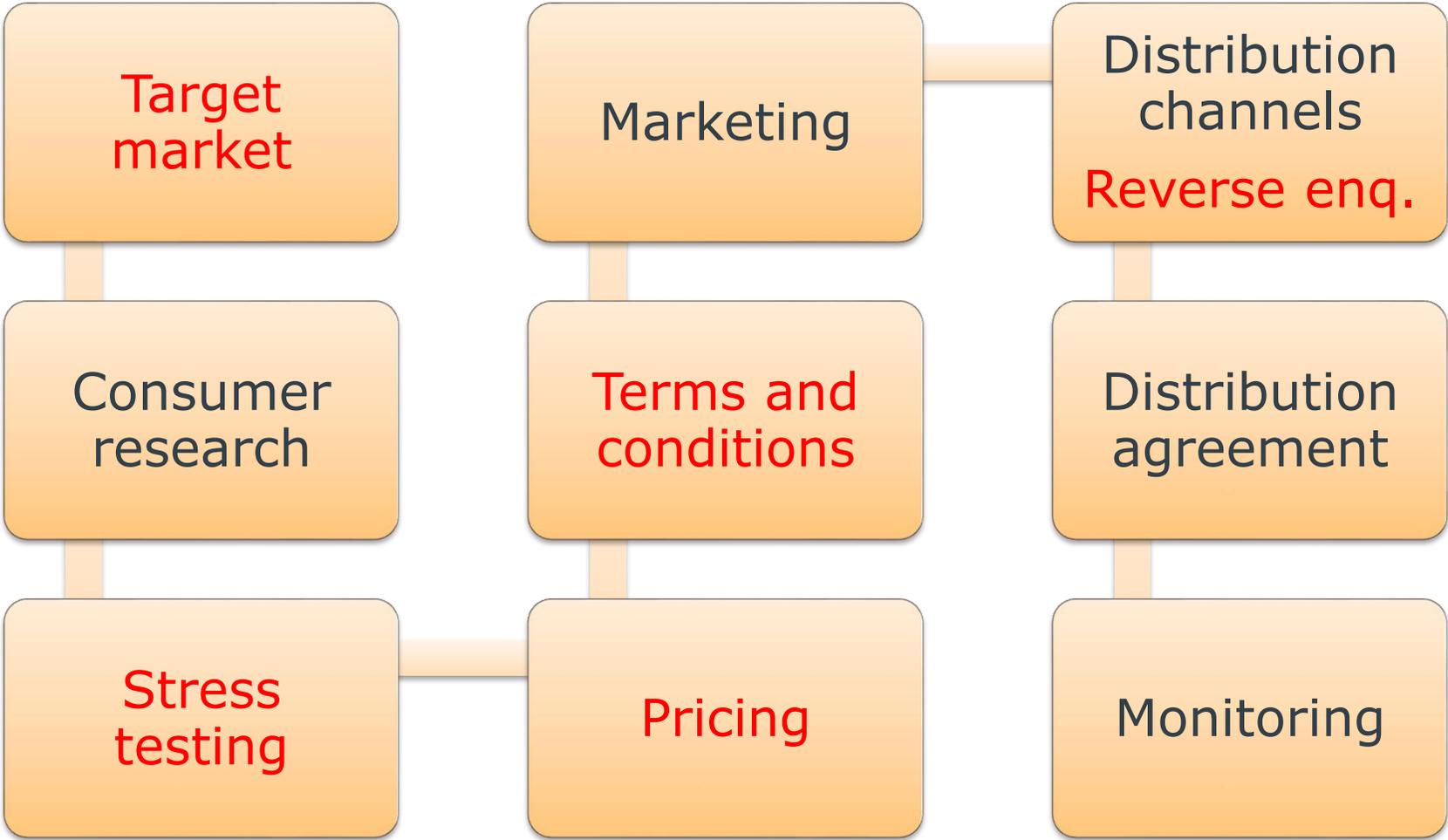
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KEY ELEMENTS AND ISSUES



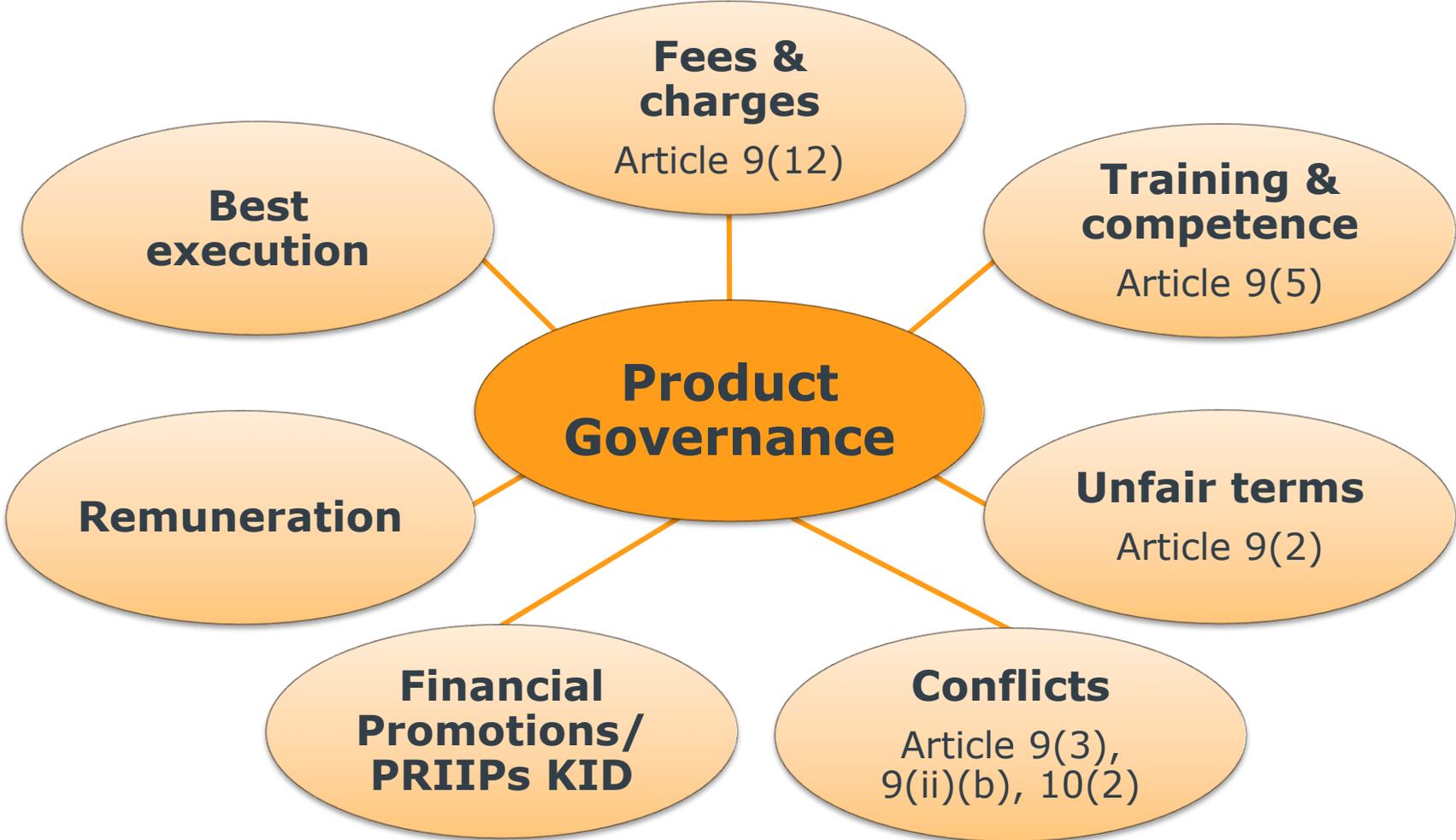
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KEY ELEMENTS AND ISSUES



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OVERLAP WITH OTHER REGULATORY REGIMES



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MIFID II KEY TERMS

- **Manufacturer:** creation, development, issuance and/or design of financial instruments (article 9(1))
- **Co-manufacturer:** any firm that collaborates with the manufacturer to create, develop, issue and / or design a product (article 9(8)) (includes unregulated & non-EEA firms)
- **Distributor:** offer or recommend financial instruments (article 10(2))

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TARGET MARKET ASSESSMENT

- Industry alignment – update from BBA

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TARGET MARKET – GRANULARITY EXAMPLE

	Cat.	Risk appetite	Sophistication	Wealth	Investment Objectives	Term	Channel
[A]	[Retail] [Prof]	[Low] [Moderate] [High] [Willingness to lose capital] [Willingness to accept counterparty risk] [Willingness to accept early redemption risk]	[Experience in relation to product (frequency / time period)] [Experience of financial markets]	Annual income: £[●] Net assets: £[●]	Returns between [●]% - [●]%	No access to capital for [●] years	[Non-advised] [Advised] [Discretionary]

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STRESS TESTING

- Disclosure of stress testing outcomes
- Common approach to methodology?
- Reverse enquiries (4 conceptual models):
 - each party undertakes its own stress testing
 - stress testing is undertaken by the manufacturer and shared with the distributor
 - stress testing is undertaken by the distributor and shared with the manufacturer
 - responsibility for stress testing is allocated between the parties contractually
- FCA's view: it is up to the industry to "innovate in a manner which results in good consumer outcomes"
- MiFID II "scenario testing" less burdensome

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PRICING

- Best execution applies
 - assessment of conflicts inherent in pricing
- Complexity of charging structures
 - ability of investors to understand / estimate costs
 - transparency
- Proportionality
 - manufacturing charges
 - distribution fees
 - enhanced MiFID II inducement rules

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DISTRIBUTION CHANNELS

- Risk rating distributors – need for industry alignment?

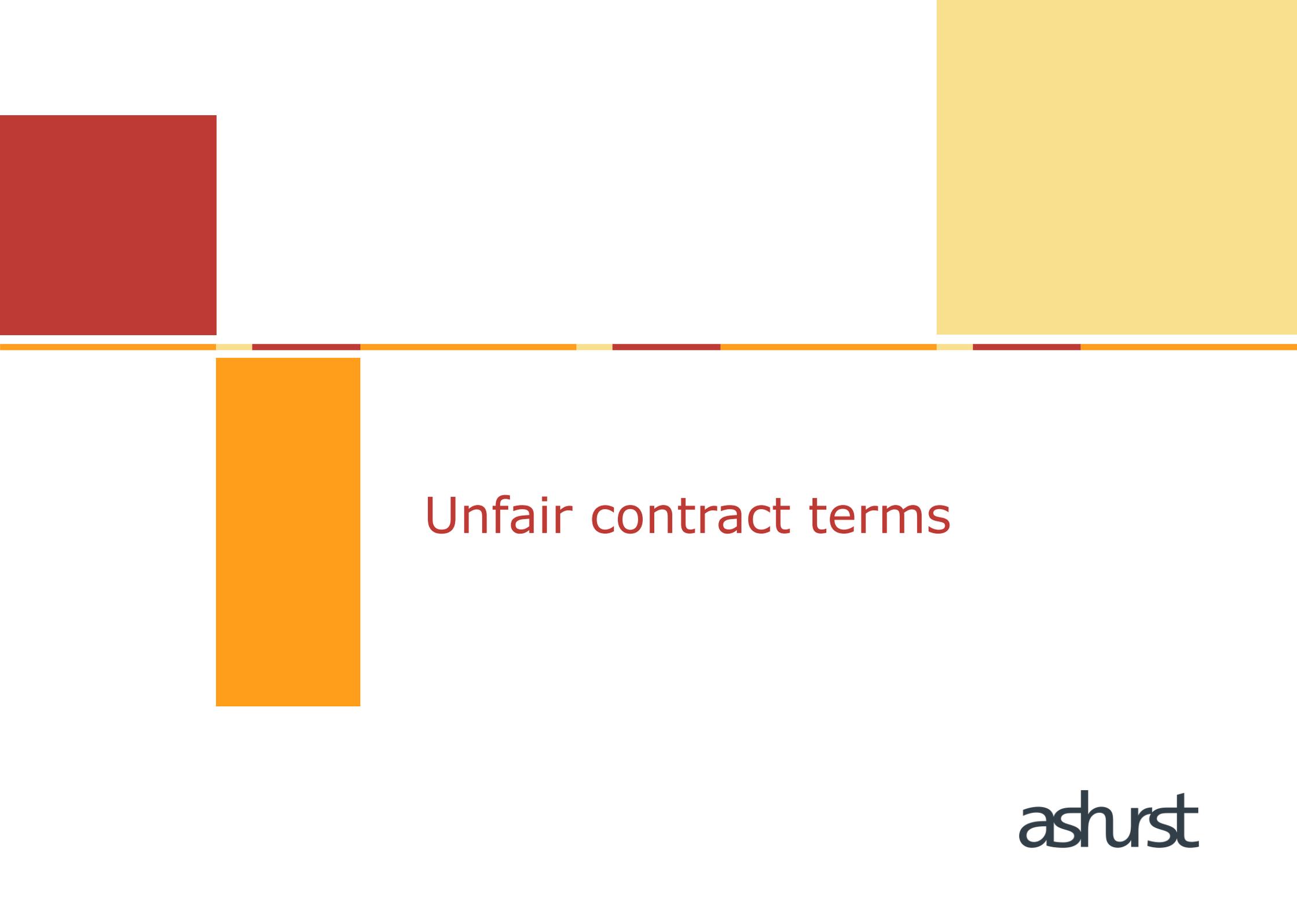
Cat.	
A	EEA global/reputable private banks and large wealth managers with the capacity to advise and manage and who also have sophisticated and high net worth clients
B	EEA mid-level private banks and wealth managers
C	Non-EEA regulated firms but with a strong reputation in its local market equivalent to that of a Category A distributor
D	Non-EEA firms equivalent to a Category B distributor
E	Independent Financial Advisors and Plan Managers

- Discretionary managers:
 - DM interface with individual retail
 - DMs of large funds (e.g. pension funds)

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REVERSE ENQUIRY

- No "reverse enquiry defence"
- Responsibility split – MiFID II "co-manufacturers"
 - written con-manufacturer agreement (distribution agreement) required (article 9(8))
 - only one target market assessment required (article 9(9))
- Timing considerations – front end compliance
 - pre-approved universe of products
 - communicate target market
 - signed distribution agreement in place
- Non-EEA distributors – requirement to consciously manage risk

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Unfair contract terms

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Unfair contract terms

BACKGROUND – WHY FOCUS ON UNFAIR TERMS NOW?

- Increased regulatory focus on structured products terms:
 - UK Consumer Rights Act (1 October 2015)
 - Gives effect to Unfair Contract Terms Directive 93/13/EEC
 - Consolidates and reforms consumer law
 - Revokes UTCCR (post 1 October 2015)
 - UCTA 1977 amended
 - FCA priority 2015 / 2016
 - Aligns with MiFID II product governance agenda:

"the design of a financial instrument, including its features, should not allow firms to mitigate and / or dispose of its own risks or exposure to the underlying assets of the product, where the investment firm already holds the underlying assets on own account."
(Article 9(2) Delegated Act)

Unfair contract terms

CONSUMER RIGHTS ACT – EXTENDING SCOPE OF UK REGIME

- Broader definition of "consumer"
 - "...acting for purposes that are WHOLLY or MAINLY outside that individual's trade, business, craft or profession"
 - Before: "...acting ENTIRELY outside that individual's..."
- Introduces express duty on the courts to consider the fairness of a term in any proceedings before them which relate to such term in a consumer contract, even if not raised by the parties
- Applies both to standard agreements and individually negotiated terms

Unfair contract terms

CONSUMER RIGHTS ACT – EXTENDING SCOPE OF UK REGIME

- Harder to use exemption as to "main subject matter"
 - under UTCCR: terms identifying the main subject matter of contract or price were not assessed for fairness if in plain intelligible language
 - under CRA: terms identifying the main subject matter of contract or price will not be assessed for fairness only if transparent and prominent
 - a term is "prominent" if it is brought to the consumer's attention in such a way that an average consumer would be aware of the term
 - "average consumer" means a consumer who is "reasonably well-informed, observed and circumspect"

Unfair contract terms

DEFINITION OF "UNFAIR TERM"

- A term will be unfair if "contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations under the contract to the detriment of the consumer"
 - Taking into account the subject matter of the contract; and
 - By reference to all the circumstances existing when the term was agreed and to all the other terms of the contract or any other contract on which it depends
- Key elements:
 - "good faith"
 - "significant imbalance in the parties' rights and obligations"

Unfair contract terms

GOOD FAITH REQUIREMENT

- **"Good faith"**
 - Implies a general principle of "fair and open dealing"
 - Terms should be transparent – "expressed fully, clearly and legibly, containing no concealed pitfalls or traps. Appropriate prominence should be given to terms which might operate disadvantageously" to the consumer
 - A trader "should not, whether deliberately or unconsciously, take advantage" of the consumers' circumstances to their detriment (e.g. lack of familiarity with the product)

Unfair contract terms

SIGNIFICANT IMBALANCE REQUIREMENT

- **"significant imbalance in the parties' rights and obligations"**
 - "The requirement is met if a term is so weighted in favour of a business that it tilts the rights and obligations under the contract significantly in its favour, for instance granting the trader undue discretion or imposing a disadvantageous burden on the consumer."
 - "[I]t should not be understood that a reduction in the price will necessarily remove or reduce the effect of a detrimental imbalance in the contract."

Unfair contract terms

OTHER OBLIGATIONS AND RESTRICTIONS

- Transparency: "A trader must ensure that a written term of a consumer contract, or a consumer notice in writing, is transparent"
 - Separate and apart from transparency element of "good faith" in "unfair term"
 - Sanction: not unenforceability, but other remedies under CRA, e.g. reimbursement, damages and specific performance.
 - Transparency requires that the term be "expressed in plain and intelligible language and it is legible"
 - Starting point is that consumers need to be able to understand their rights and obligations
 - Not transparent if the term requires some "legal mining to bring it to the surface ...". This is particularly true for complex pricing terms or those which involve potentially surprising, significant or onerous obligations being imposed on the consumer in the future

Unfair contract terms

OTHER OBLIGATIONS AND RESTRICTIONS

- Ban on exclusions of liability for failure to perform a service with reasonable care and skill and on limiting liability to less than the price paid - unenforceable
- Incorporation into the contract of voluntary statements made outside the contract:
 - Anything that is said or written to the consumer, by or on behalf of the trader, about the trader or the service, if it is taken into account by the consumer when entering into the contract or exercising any right under it – e.g. oral statements made by sales teams, financial promotions, website information and client notices or announcements
 - Entire agreement terms will be contrary to this requirement, and therefore unenforceable

Unfair contract terms

VULNERABLE TERMS

Term	Issue	Mitigation
<p>Variation right to vary terms unilaterally without valid reason, including price</p>	<p>Term could be used to force the consumer to accept unanticipated costs or penalties, new requirements or reduced benefits.</p>	<p>More likely to be fair if: (i) scope of variation clause is reduced for valid reasons e.g. changes in law specifically minimising a firms discretion; or (ii) where it includes a duty to provide notice together with a genuine cancellation right.</p> <p>Note: An obligation to act reasonably is not enough.</p>
<p>Unequal cancellation / termination rights ability for a firm to dissolve / suspend the contract on a discretionary basis, without granting the same right to the investor</p>	<p>Cancellation without valid reason or vaguely defined reason. Especially, where it would still be possible or practicable to conclude the contract.</p> <p>Cancellation without reasonable notice (indeterminate contracts) unless serious grounds for cancellation apply.</p>	<p>(i) Draw attention to the risk of cancellation. (ii) Circumstances should be clearly and specifically described (none of the circumstances should be within the firm's control). (iii) Include notice requirements.</p> <p>Note: suspensions clauses should be treated in the same way.</p>

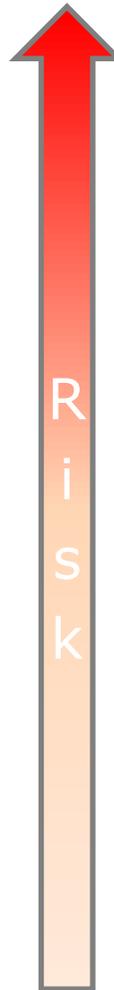
Unfair contract terms

VULNERABLE TERMS

Term	Issue	Mitigation
<p>Exclusion of liability for: (i) breach of statutory duty; (ii) negligence; (iii) to adequately perform a term of the contract; or (iii) "consequential loss"</p>	<p>Note: Excluding liability for good faith errors or omissions in an issuer or calculation agent's calculations or determinations, caused by negligence or otherwise, will be an unfair contract term.</p> <p>Meaning and implication of term "consequential loss" could be misunderstood by consumers, and may exclude certain risks that should not be fairly excluded.</p>	<p>Exclusion of liability for loss more likely to be deemed fair where the losses were neither (i) foreseeable by either party when the contract was formed; nor (ii) caused by any breach on the part of the firm.</p>
<p>Entire agreement clauses</p>	<p>Oral statements / other literature may form part of a contract where it is taken into account by an investor in making an investment decision.</p>	<p>Entire agreement clauses will be unenforceable.</p>
<p>Offsetting debt offsetting a debt owed to a firm against a claim from an investor</p>	<p>Since the law will generally allow a consumer to deduct the amount of any arguable claim it has against the trader from anything that it owes the trader, excluding the consumer's right of set-off will generally be considered to be unfair.</p>	<p>Consider removing such an exclusion.</p>

Unfair contract terms

VULNERABLE TERMS – STRUCTURED PRODUCT SPECIFIC



Term	Issue	Mitigation
Early redemption of the securities	<p>Such terms are often used in order grant the issuer certain options either where for illegality reasons or in certain circumstances at the discretion of the issuer (including matters impacting hedging arrangements).</p> <p>May be deemed unfair where they grant the issuer a unilateral right to terminate to protect its position whilst being potentially detrimental towards the consumer.</p>	<ul style="list-style-type: none"> (i) Make clear that this is a last resort (e.g. following adjustment / substitution). (ii) Transparency around circumstances in which term would be relied upon (narrow scope of the event) and its consequences. (iii) Method of calculating early redemption amount clearly set out (e.g. third party dealer poll). (iv) Early repayment amount should not be less than the capital protected amount (if applicable). (v) Do not deduct issuer's costs of unwinding hedge. (vi) Notify holders.
Substitution of the underlying assets	<p>May be drafted too widely and so theoretically open to abuse.</p> <p>Transparency is of particular concern in relation to events affecting the issuer's hedging arrangements, as such arrangements are not disclosed to investors, so it is not possible for an investor to make an informed assessment of the potential circumstances that could trigger the event and the potential outcome.</p>	<ul style="list-style-type: none"> (i) Transparency around circumstances in which term would be relied upon (narrow scope of the event) and its consequences. (ii) Criteria around selection of replacement underlying assets should be as prescriptive as possible. (iii) Objective to preserve economic rationale for the investor. (iv) Consider granting investors a put right prior to substitution. (v) Notify holders.
Adjustments to the Terms and Conditions of securities	<p>Impact of the terms often results in the transfer of risk following a specific event from the firm to the investor. Resulting in a significant imbalance in a party's rights.</p>	<ul style="list-style-type: none"> (i) Objective of the adjustment should be to preserve prior economic terms. (ii) Transparency around circumstances in which the term would be relied on and its consequences. (iii) Limit adjustments impacting capital protected amount. (iv) Take into account referenceable adjustments made by third parties (e.g. ISDA determinations). (v) Notify holders.

Unfair contract terms

RISKS

- **Legal risk**
 - term deemed unenforceable or interpreted in favour of customer
- **Reputational risk**
 - FCA requires undertaking – publicity
- **Product intervention risk**
 - likely to be a key focus in the future
- **Prudential risk**
 - potential costs being different from those thought to be relevant when the product was devised
- **Governance risk**
 - potential for management to be blamed



PRIIPs, product
governance & unfair
contract terms

Key cross-overs and implementation
considerations

PRIIPs, product governance & unfair contract terms

THE OVERLAPS – PRODUCT DESIGN

	PRIIPs KID	Product governance	Unfair contract terms
Product approval	Compliant KID required?	Appropriateness of product for target market	Remove / minimise unfair terms
Risk rating	SRI applied	Method for risk rating products	Disclosure in plain language
Target market	Specify target market	Specify target market	Intended target market may dictate whether a term is deemed "fair"
Communications	Prescribed template	Required to communicate: target market, key features and risks, range of potential outcomes	T&Cs and other communications must be assessed for fairness
Costs and charges	Disclosure	Disclosure Proportionality Transparency / complexity	Transparency / complexity

PRIIPs, product governance & unfair contract terms

THE OVERLAPS – DISTRIBUTION AGREEMENT CONSIDERATIONS

	PRIIPs KID	Product governance	Unfair contract terms
Distribution agreements*	Define who has responsibility for all aspects of product governance	Define who has responsibility for production, provision and revision of the KID Includes consideration as to whether information will be provided by the party not responsible for producing the KID	Define who has responsibility for complying with the unfair contract terms regime. Includes a responsibility to review and update the product terms (and supporting communications)

* Distinguish approach between EEA and non-EEA counterparts based on conscious management of risk

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