THE FINANCIAL SERVICES PRACTITIONER PANEL

RESPONSE TO FSA CONSULTATION PAPER 12/09

'CONSUMER REDRESS IN RESPECT OF UNSUITABLE ADVICE TO INVEST IN ARCH CRU FUNDS'

23 JULY 2012

Introduction

The Financial Services Practitioner Panel ('the Panel') has taken a particular interest in the debate around consumer redress for Arch cru investors, and whether or not it is appropriate for the FSA to use the section 404 ('s.404') power in FMSA in this instance.

We welcome the engagement from the FSA with us on this topic to date, and have provided our answers to selected consultation questions below.

Executive Summary

- We share the FSA's disappointment in the indications that there has been mis-selling of Arch cru funds
- However, we do not believe that the 'widespread or regular failure' legal tests for the use of s.404 powers in the case of Arch cru have been met, and are concerned that the paper fails to differentiate between different types of consumers
- In cases where there is not widespread detriment across the market and consumers are engaged, we believe industry should be encouraged to resolve problems in the first instance
- The regulator needs to be aware of the unintended consequences in a case such as Arch cru, where the use of section 404 powers could lead to
    - the setting of an inappropriate regulatory precedent going forward and
    - firm failures, which could lead to further FSCS compensation scheme levies, and raise issues of equity and moral hazard as 'good' firms pay for the mistakes of others

Answers to selected consultation questions:

Q2: Do you have any comments on the file review?

We share the FSA's disappointment in the outcome of the file review. We agree that this review indicates there were a large number of advisers who misunderstood the risks inherent in an Arch cru sale, and that there is a high likelihood there has been mis-selling for a number of consumers.

We support efforts to achieve consumer redress in an instance such as this, although we disagree with the FSA regarding which tool should be used. We believe there are alternative options to a section 404 available which would also provide consumers with the opportunity to have the circumstances of their sale reviewed.

Q4: Do you agree with our assessment of the options available for delivering consumer redress?

Although we are supportive of securing consumer redress for those who were mis-sold, the Panel does not agree with the FSA assessment of the options available for delivering consumer redress.

The Panel is concerned that there is increasingly a failure to differentiate between different types of consumers in the setting of regulatory policy, and that regard to consumer responsibility is being lost. There needs to be a clear distinction for the purposes of sales and regulation between relatively inexperienced retail consumers, who are less likely to actively seek redress or go to the FOS on their own accord, and a range of more sophisticated clients. The latter are more likely to both actively seek advice and to complain in instances where they believe they have not received an appropriate level of service, if they receive information to that effect.

We believe that the PPI case involved a large number of the former type of client, and this would have been an instance where we could have understood the rationale for a section 404 power being used. However, as the Arch cru case involved advised sales, the relevant clients are likely to have been more engaged in the sales process than the average PPI consumer. Although we agree with the FSA that there is evidence that there was mis-selling, we do not agree with the regulator's assessment that there are likely to be significant barriers to these consumers pursuing their own complaints. In instances where there are better informed consumers, a lack of trust that they should be able to complain to their firm raises questions around whether it is not reasonable to also expect a certain level of consumer responsibility and engagement in seeking potential redress.

The Panel also has concerns regarding the potential unintended consequences of this Scheme. It is likely that the implementation of this Scheme would lead to a number of firms failing, with their liabilities subsequently picked up by the FSCS. As you are aware, FSCS levies on firms have been very significant in the past year. There is a question as to fairness and the potential 'moral hazard' of firms who were not involved in mis-selling having to pay for the mistakes of others. There is a concern that there may be firms in the future who will not be incentivised to avoid the poor

sales practices of competitors, as they know they are likely to have to pay for the fall out regardless.

In addition, as the policy team is aware, there are potential issues relating to this case and the ability to secure Professional Indemnity Insurance.

Q5: Do you agree with our assessment that the legal tests for making a consumer redress scheme have been met?

The Panel does not agree that the legal tests for making a s.404 consumer redress scheme have been met.

In order to satisfy the conditions in section 404 of FSMA, there needs to appear to be widespread or regular failure by firms to comply with requirements applicable to carrying on an activity. We recognise that 'widespread or regular failure' is not defined in statute. However, we believe that the Arch cru case fails to meet a reasonable standard for this.

On neither the number of consumers affected or the number of firms involved can the mis-selling in the case of Arch cru be seen as 'widespread'. The FSA states it has identified 795 firms it believes has sold Arch cru funds. Out c. 27,000[1] financial services firms in the UK, this represents less than 3% of the firm population. The paper also states it believes using the Arch cru scheme would deliver c.£110m of redress to between 15,000 to 20,000 consumers in total. In contrast, for PPI, the Financial Ombudsman Service reported 157,716 PPI complaints to their organisation (with a significant number of complaints that year resolved through firms themselves in the first instance) in 2011/12 alone[2].

The paper states that 'In our view, the file review provides strong evidence that there has been a widespread failure by firms to comply with requirements to provide suitable advice…' It then sets out the percentage of firms (out of those involved) who failed to categorise Arch cru according to an appropriate risk category. This seems to imply that the FSA is interpreting 'widespread failure' as failure within a given set of firms, rather than failure across the market place. This is not a reasonable interpretation, and not in line with the spirit in which the original power was granted, which was to deal with issues of mass detriment across the market.

There are significant implications for using a tool such as section 404, which was designed with genuine widespread failures in mind, in cases such as this. Firstly, the use of this tool will set a regulatory precedent going forward. There is value in having a culture where firms are encouraged to develop strong practices of their own for dealing with issues of detriment or mis-selling. There are strong concerns in the industry, that should this set a precedent whereby 'widespread detriment' is defined too loosely, there is the possibility of the regulator staging future s.404 intervention also in cases of minor infractions.

Instances of mis-selling are deplorable. However, in all industries there are occasions when mistakes are made. We believe that firms should be prompted to address any

[1] As quoted by the FSA in e.g. The FCA Approach publication
[2] Source: Financial Ombudsman Service's 2011/12 Annual Review

issues quickly, and appreciate the regulator's role in ensuring that this is done. However, we also believe that in an ideal situation, such prompting should not be necessary and firms should act quickly and decisively to address any market issues as they arise. We would like in the future for firms to be able in the first instance to resolve issues with consumers directly, in cases where there is not evidence of a widespread industry problem. The regulator could play a role in helping to foster such behaviour in industry through monitoring and sanctions of firms who fail to perform.

It is also worth noting that although the use of the section 404 power would not entail a retrospective application of selling rules, it would involve the retrospective application of the power, as the power in its current form only became available to the FSA in 2010.

Q9: Do you have any comments, or evidence or analysis to add, on our cost-benefit analysis?

As we have indicated in our answers to other questions, we are sceptical about the potential redress estimates calculated under the alternative options considered. We believe a 10% reach under 'issuing a call to action to consumers' seems very low, and does not seem to take into account the fact that the type of consumer involved in Arch Cru mis-selling is likely to be more engaged than more vulnerable retail consumers, and therefore also more likely to complain.