THE UK FSA’S EFFECT ON FUTURE OF INVESTOR CAPITAL

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TIMELINE

- 25 Apr 2012
  Finalised Guidance

- 28 Nov 2011
  Guidance Consultation

- 25 Jan 2011
  Product Intervention Discussion Paper

- 24 Feb 2010
  Peter Smith’s Speech

- c. 2011
  Catalyst / ARM

- c. 2009
  Keydata / SLS / Lifemark

- c. 2005
  Shepherds Select Fund
SHEPHERDS SELECT FUND

• Launched in May 2002.
• Funds of $46 million.
• “Almost totally invested in fractions of [traded endowment and traded life] policies, through American broker Mutual Benefits Corporation (MBC).”
• “MBC was placed into receivership and its license suspended by the Securities and Exchange Commission (SEC) in May 2004.”
• “Shepherds Select Fund was suspended almost immediately and went into liquidation on 6 May 2005, affecting about 50 UK and 50 overseas IFAs and their clients.”
• Used as an example in Peter Smith’s speech: “This was the first [fund] in the UK to invest in this asset class, but the fund’s management team was not able to buy enough whole policies to gain a sufficient risk spread. The fund collapsed in May 2005 and left UK investors facing losses of approximately £22 million.”

Sources:
http://www.citywire.co.uk/new-model-adviser/article/a276630
http://www.citywire.co.uk/new-model-adviser/article/a374178
KEYDATA / SLS / LIFEMARK

• “Keydata [Investment Services Ltd] ... designed and distributed structured investment products. These were distributed both directly and via a network of independent financial advisers (IFAs). In addition to other activities, Keydata invested customers’ money in bonds issued by one of two Luxembourg-based companies, SLS Capital SA and Lifemark SA, which used the money raised to buy portfolios of US senior life settlement policies.”

• “During the course of a wider investigation we discovered that several Keydata products may not have been eligible for ISA (Individual Savings Account) status and could create an unexpected tax liability cost for Keydata and investors. Keydata could not pay this and ... was put into administration on 8 June 2009 with PwC appointed as administrator.”

• “PwC discovered that £103m of investors’ money in bonds issued by SLS may have been misappropriated. In relation to SLS, the FSCS has, so far, paid out more than £50m to approximately 4,700 investors.”

• “Investors in bonds issued by Lifemark ... remain unable to cash in their investments because Lifemark has liquidity problems. The FSCS concluded that, for its purposes, these bonds now have no value.”

Sources:
KEYDATA / SLS / LIFEMARK

• “As the Chairman outlined, one of the most complex and time-consuming defaults we dealt with was Keydata Investment Services Limited. More than 60 per cent of the total new claims we handled over the year related to Keydata, some 27,000.”
• “The costs from the failure of Keydata triggered the first cross-subsidy between different industry sectors. We paid out a total of £214m in compensation to consumers for Keydata claims.”
• “A key focus of the FSCS Board is on our accountability to the industry which funds us. The failure of Keydata and other investment businesses gave a new prominence to this accountability in 2010/11.”

Sources:
CATALYST / ARM

• “ARM Asset Backed Securities SA (ARM), an securitisation vehicle based in Luxembourg ... issued the ARM Assured Income Plan and ARM Capital Growth Bond products ... listed on the Irish Stock Exchange but are currently suspended from trading.”

• “From 2006, Catalyst [Investment Group] had been distributing ARM bonds, via IFAs, to UK investors. It has sold the ... products to 2,079 UK customers with a total value of £75.5m.”

• “In July 2009, [the FSA] told Catalyst that ARM did not appear to be authorised to issue the bonds. That same month ARM formally applied for authorisation in Luxembourg and it also took steps to transfer to Ireland in May 2010.”

• “ARM was not able to meet the conditions [of the Irish regulator, the Central Bank of Ireland]. In August 2011, the [Luxembourg regulator, the] CSSF announced it would not authorise ARM either.”

• In September 2011, the FSA fined Rockingham Independent Ltd £35,000 for recommending unsuitable investments, including investments in ARM products. Both Catalyst and Rockingham are authorised by the FSA and their actions are therefore covered by the FSCS.

Sources:
http://www.fsa.gov.uk/consumerinformation/firmnews/2012/rockinghams.shtml
PETER SMITH’S SPEECH

- Head of Investments Policy, Conduct Policy Division, FSA
- European Life Settlement Association (ELSA) Conference in London
- Titled “FSA sets out concerns about Traded Life Policy Investments”
- “…we should be far more sceptical in considering whether innovation is in every case a net benefit…”
- “…where in the past we might have concentrated on sales practices to try to ensure good outcomes for consumers, we will now intervene earlier, in product design and the marketing by providers of those products to distribution firms.”
- “We have had to take action with a number of firms already and so we would be very concerned to see a rapid increase in the size of this market.”
- “It is never enough to assume that it is the adviser’s responsibility alone for advising their clients and delivering compliant and suitable recommendations to invest in the products.”
- “We would agree that providers are not responsible for another firm’s advice to the end customer, but they have a duty to help the distributor sell the product and achieve good customer outcomes.”
- “We have seen instances where the financial promotions, marketing materials and other information designed and approved for use by IFAs and their clients have fallen well below the standards we require. We also have concerns about the general quality of marketing literature from providers.”
PETER SMITH’S SPEECH (CONT’D)

• “...there is a risk of unrealistic performance illustrations due to fund managers manipulating valuations by using shorter life expectancy figures to calculate future payouts. This is an area we are monitoring closely.”
• “...we would not expect to see significant proportions of any client’s portfolio invested in TLPIs.”
• “...it is a matter of great concern to us that we see commission rates being offered to advisers which are well out of line with market norms.”
• “We expect providers to be clear about the target market for their products, to understand when the product will and will not perform, to disclose and explain all of this clearly to distributors, and to monitor what actually happens.”
• “We expect advisers to understand the risks inherent in TLPIs, to explain these fully to their clients, and to recognise that these products are unlikely to be suitable for many clients.”
• 4 Oct 2010: ELSA releases its Code of Practice, drafted largely in response to Peter Smith's concerns. The Code outlines ‘best practice’ in many areas of the industry, including retail distribution.

“6.4: Starting with the most radical interventions and moving to less intrusive, we explore the following options in this chapter:
- product pre-approval;
- banning products;
- banning or mandating product features (including setting minimum standards for products);
- price interventions;
- increasing the prudential requirements on providers;
- consumer and industry warnings;
- preventing non-advised sales; and
- additional competence requirements for advisers.”

"6.47: We could adopt less interventionist means to steer the market away from product designs about which we have concerns. For example, in February 2010, Peter Smith, Head of Retail Investments Policy at the FSA, made a speech about the risks of traded life policy investments. We could do more to provide early warnings about products we regard as posing the risk of significant detriment.”
PRODUCT INTERVENTION DISCUSSION PAPER (CONT’D)

• “6.49: We could look to follow this approach and publish a list of products that we regard as being generally unsuitable for the mainstream, retail market. This list might include, for example:
  • traded life policy investments;
  • some of the more complicated structured products; and
  • leveraged Exchange Traded Funds.”

• “6.50: Such a list would not ban the products, but would make it clear that the starting point is that these products are unsuitable for most retail customers. It would still be possible for a distributor to recommend the product, but this list would be a signal that the product is likely only to be suitable for certain segments of the retail market (for example, sophisticated customers capable of fully understanding the way in which the product works and the likelihood of it failing). We would not expect the product to reach the mass market, would not expect it to be marketed widely and would expect extensive research and justification when making it available.”

Source:
Press release titled **“FSA warns against 'toxic' traded life policy investments”**

“The Financial Services Authority (FSA) has issued guidance to warn that traded life policy investments (TLPIs) are high risk, toxic products that are generally unsuitable for the majority of UK retail investors and should therefore not be promoted to them.”

“TLPIs are known as ‘death bonds’ because investors are putting their money into a pooled investment or fund which invests in US life insurance policies.”

“Evidence from the FSA’s work to date has found significant problems with the way in which TLPIs are designed, marketed and sold to UK retail investors.”

“Margaret Cole, FSA managing director, said: “TLPIs are toxic products which pose significant risks for retail investors.””

“For now, we want to make our message about these products clear – they are completely unsuitable for most UK retail investors.”

Guidance included “In some models, yields are promised to previous investors, which can only be sustained by using new investors’ money, so the model in effect ‘borrows’ from itself and therefore appears to share some of the characteristics of a Ponzi scheme.”
• Immediate and significant press and market reaction.
• 30 Nov 2011: The Board of EEA Life Settlements Fund PCC Limited suspends dealings in the fund.
• 5 Jan 2012: ELSA meets with the FSA.
• 6 Feb 2012: ELSA responds to the consultation, recommending that the FSA work with the industry to propose targeted regulations to protect retail investors and including a list of ‘key questions for investors’ based on its Code of Practice.
• 20 Mar 2012: ELSA meets with the FSA.

Sources:
http://www.eeafmg.gg/PDFs/Life_Settlements/Fund%20Suspension.pdf (EEA's Announcement)
Press release titled “FSA confirms traded life policy investments should not generally be promoted to UK investors”

“The Financial Services Authority (FSA) has confirmed guidance that traded life policy investments (TLPIs) are high risk products that should not be promoted to the vast majority of retail investors in the UK.”

“Basically, a TLPI investor is betting on when a particular set of US citizens will die…”

“The TLPI retail market is worth £1 billion in the UK and we were very concerned that it was likely to grow even more.”

“There was a concern that we were witnessing a repeating cycle of unsuitable sales followed by significant customer detriment in the TLPI market. Following publication of the guidance for consultation, this threat has receded.”

“This is an interim measure – we believe that TLPIs and all unregulated collective investment schemes should not generally be marketed to retail investors in the UK and will be publishing proposals soon to prevent them being promoted except in rare circumstances.”
FINALISED GUIDANCE (CONT’D)

• “mass market retail investors” changed to “the vast majority of retail clients”.
• “Conflicts of interest” added to risk factors.
• References to “toxic”, “death bonds” and “Ponzi” removed.
• No discussion about what constitutes “good” and “bad” products, or consideration of a set of best practices.
• “Following our two meetings with the FSA in January and March 2012, we are pleased that the FSA has admitted that the use of the word toxic may have led to some confusion for some customers. The FSA has also made clear that the guidance does not apply to professional and institutional investors. ELSA will continue consulting with the FSA on the new proposed rules to protect investors.”

Sources:
http://www.fsa.gov.uk/static/pubs/guidance/fg-tlpis-feedback.pdf (Summary of Feedback Received)
THOUGHTS ON THE FUTURE

• June 2012: “As part of our consultation on new rules for the sale of Unregulated Collective Investment Schemes (UCIS), scheduled for the second quarter of this year, we plan to consult on new rules preventing the marketing of TLPIs to the vast majority of retail clients. If rules are introduced following this consultation, we would expect them to come into force some time in 2013.”
• Luxembourg’s CSSF, the Central Bank of Ireland and the Irish Stock Exchange are in consultation with the FSA and may introduce similar rules.
• 26 Sep 2012: ESMA has agreed to address the Second ELSA Investor Summit.
• Some firms will continue to promote Life Settlement funds to UK retail investors on the basis that IFA firms are able to provide detailed and robust justifications for their suitability assessments.
• However, and anecdotally, Professional Indemnity (PI) insurers are telling the IFA firms they cover that if they sell Life Settlements their PI policies will not pay out.
• Firms dealing with institutional investors, rather than retail investors, can expect to have to address their investors’ questions and concerns about the FSA’s announcements.
• In contrast, some institutional investors see the announcements as an opportunity to invest in the market at attractive prices.