

Financial Services Consumer
Panel response to:
Consultation Paper 45 -
Conduct of Business
Sourcebook

Conduct of Business

Financial Services Consumer Panel response to Consultation Paper 45: *Draft Conduct of Business Sourcebook*

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Note

References to paragraph numbers are to those in *CP45a The Conduct of Business Sourcebook Part I and II* unless otherwise stated. References to Rules or Guidance (eg 6.6.21R) are to *Part III of CP45a* unless otherwise stated.

Introduction

This paper is the response of the Financial Services Consumer Panel (‘the Panel’) to the Financial Services Authority (FSA) Consultation Paper 45, ‘*The Draft Conduct of Business Sourcebook*’. The FSA established the Panel to advise the FSA Board on the interests and concerns of consumers and to report on the FSA’s effectiveness in meeting its consumer protection and public awareness statutory objectives. Further information about the Panel is available on page 17.

Summary

- a. The Panel recognises that the FSA needs to have a consistent and workable COB regime in place at N2 and that designing such a regime has been a significant task. The proposals in CP45a harmonise the existing rule books but cannot be said to be a review “from first principles” of the COB regime. While we understand the scale of the task involved in getting a rulebook in place quickly, we think that a further review from first principles will be needed. We recommend that the FSA should commit itself to such a review and inform the industry of that commitment. We hope that the effort required to prepare for N2 will not make the FSA reluctant to take on this further work.
- b. Before this fundamental review can be carried out the present proposals need attention in several areas, outlined below.
 - The relationship with the new risk-based approach to supervision, as set out in *A New Regulator for the New Millennium* needs to be clarified.
 - The proposals are not obviously informed by existing consumer research and will have to be modified in the light of research which the FSA has itself commissioned.

- The use of cost-benefit analysis to justify one option which has already been chosen is not acceptable. Nor is it self-evidently true that harmonization at the level which involves the lowest cost to providers is necessarily desirable: such reduction in cost needs always to be tested against possible increases in consumer detriment. This may be particularly important in relation to record-keeping requirements, where the combined impact of changes to the rules and changes to the FSA's own supervision procedures need to be considered from a consumer viewpoint.
- The document does not deal adequately with the changes in practice and the need for consumer protection which follow from the rapid development of e-commerce.

Panel response to Consultation on COB Sourcebook

Need for a first principles review of policy

1. The production of the Conduct of Business Sourcebook (COBS) has clearly been constrained by the need to have a workable, harmonised set of rules in place when the new Financial Services and Markets Act comes into force. At the time the COBS project started it was thought that this would happen in July 2000. It is now expected to be early in 2001. Understandably, this has meant that the draft COBS is primarily an attempt to consolidate the numerous existing rulebooks into a single regime, rather than an attempt to construct from first principles a regime centred on consumer protection. Nor has the draft been formulated in line with the FSA's new risk-based approach to regulation, as set out in *A New Regulator for the New Millennium*.
2. For example, distinctions are retained (eg between packaged products, designated investment business and pure protection products) without analysis of the reasons for the distinction or the impact of, for example, excluding pure protection products from the polarisation regime.

3. Again, paragraph 37 (ii) states that the new regime has been “modified where necessary to help e-commerce” but this is limited to guidance on transferring the existing regime to new technologies rather than a review of whether the new regime is appropriate or effective for new technologies such as the internet and WAP telephony.
4. The danger is that what is primarily consolidation rather than policy review gets set in stone at a time when markets are changing even more rapidly than before. For example, we think there is potential for product sales through internet “supermarkets” to cause the same problems as the polarisation regime was set up to tackle even if providers are not technically giving advice. An example is a situation where a product provider sets up an apparently “independent” search and purchase facility such that products from connected companies always appear at the top of a “best buy” list. We understand that this potential problem could be minimised by surveillance activity, but while this may be practicable with a small number of sites, it may not be feasible to check all suppliers as the market expands.
5. We believe that a further review of the conduct of business requirements from first principles is needed. Despite the suggestion in paragraph 1.6 we do not think that these proposals do constitute such a review. We note that the FSA does envisage the need for COBS to be reviewed over time (paragraph 1.7). We think that the FSA needs to give a clearer commitment to a wide-ranging, fundamental review now. This is necessary to ensure that the industry does not gain the erroneous impression that all the changes likely to be required are contained in this draft or highlighted in the list of forthcoming developments set out in paragraph 1.7. The FSA should also set out a timescale for the review.
6. Further, a mechanism is needed to ensure that new developments (such as the outcome of the polarisation review, disclosure research, changes in the marketplace) are fed into the COBS regime, even before the necessary fundamental review.

7. The CP itself makes little attempt to assess the impact on consumers of the changes proposed or to present the issues in a way accessible to bodies who may wish to consider the consumer impact in responding to the consultation. It would have been helpful to have a short guide to the consumer implications of the sourcebook and the consumer issues on which feedback was desired.
8. Some of the questions raised by the Sourcebook are matters of scope where the FSA's decisions are influenced or constrained by policy decisions taken elsewhere. For example, HM Treasury has yet to publish a final version of the Financial Promotions Order and the Regulated Activities Order. For that reason, the parts of this response relating to the scope of the regime need to be considered by HM Treasury as well as FSA.
9. Until a review from first principles is carried out, we do not think that there should be a presumption that harmonisation at the level which is lowest cost to industry is necessarily desirable. This presumption does appear to underpin parts of the present draft COBS, such as the proposed changes to the record-keeping requirements discussed further in paragraphs 30-32 below.
10. The comments in the rest of this paper relate primarily to the draft COBS as published and attempt to highlight areas where the potential for undue consumer detriment remains and/or where the case for the FSA's proposed option has not been fully made. A number of detailed points are made in the Annex. We do not attempt to set out here a blueprint for a regime re-designed from first principles.

Research on consumers

11. There is little evidence in the consultation paper that the assumptions about consumer behaviour which underpin COBS are grounded in consumer research. This is a weakness, because it increases the danger of making inappropriate or premature policy choices.

12. For example, there is no evidence of any research on the profiles or behaviour of e-commerce users or analysis of how this might change. We are concerned that this might have led the FSA to over-estimate the sophistication of e-commerce users, particularly given the growth in the availability of digital television which is expected over the next few years. It is also difficult to see how an effective financial promotions regime can be devised without checking how consumers respond to financial promotions in practice. We strongly recommend that the FSA carries out research on consumers' buying patterns and behaviour when using electronic channels. We would be happy to share any of our own research which might be relevant.
13. Our own recent research on distance selling of financial services (referred to further in paragraph 36 below) leads us to conclude that the FSA needs to do more to police advertising of products and that it should test whether a sample of advertisements are found to be "clear, fair and not misleading" by consumers in practice.
14. It is important that the FSA makes considered use of research, especially research which it has itself commissioned. For this reason it is surprising to see changes to the "Key Features" document proposed before the FSA's research in this area has been concluded. The FSA should wait for its research findings before making proposals, in order to minimise the confusion to consumers and the resistance from firms which would arise from making further changes in the light of research. In particular, it would be unwise to abolish the requirement to send post-sale key features unless a strong case for doing so had emerged from the research. Indeed, we support the retention of post-sale key features unless it can be demonstrated that consumers do not need them.
15. The FSA also needs to test how people deal with material made available electronically rather than in hard copy. Parts of the COBS rules make assumptions about what constitutes the e-commerce equivalent of traditional regulatory processes which may be ill-founded. For example, it

may not be appropriate to assume that simply making key features available on a website is equivalent to sending a hard copy through the post. Consumers need to download or print out the key features document in order to have a permanent record of it as they may find that the document is no longer on the website when they wish to read it. This puts the onus on consumers to recognise the need to download or print material in order to have a permanent record, whereas if they were buying by other means (eg phone, post) a copy of the key features would have been sent to them automatically.

16. It is also not clear that any consumer testing has or will underpin regulatory assumptions about what constitute effective systems to prevent UK consumers from taking up financial promotions not “directed” at the UK as defined in the financial promotions rules (see 3.4.1R, Table 3.4R). We think that such research is needed if the FSA is to be effective in monitoring and enforcing its financial promotion rules and in advising firms which seek to comply about appropriate ways of doing so.

17. COB 3.8.3G and COB3.9.5 state that firms will be required to identify the FSA as its regulator in direct offer financial promotions. This decision will need to be reviewed in the light of research on regulatory status disclosure post-N2 which the FSA has conducted to ensure that confusing anomalies do not arise.

18. Ideally, the research we propose would be conducted and used to inform policy decisions before N2. If (even with new N2 date) this is impossible then the FSA should set out a programme of work post-N2.

Cost benefit analysis

19. We have concerns about the way in which cost benefit analysis is used in this consultation. CBA should be used to compare policy options, not simply to provide a case for a selected option. It also needs to take full account of consumer detriment as well as costs to industry to determine an appropriate consumer protection regime.

20. The draft rules place a requirement on former SFA firms to supply terms of business. However, execution-only transactions are exempt from the requirement. The case for including execution only is not tested as a policy option, even though there has been a steep rise in sharedealing by private customers since the end of last year, much of it likely to be execution-only and, possibly, fuelled by new investors, unfamiliar with the market.

Table 1: Number of online brokerage accounts, Q41998 – Q41999	
Quarter	Number of online accounts
Q4 1998	12,000
Q2 1999	45,000
Q4 1999	190,000
Source: Datamonitor estimates	

21. If this option has been considered and rejected the FSA should say so and explain why, but it is hard to see why this option did not at least warrant consideration in a CBA. Meanwhile, the FSA should research the increase in sharedealing with a view to identifying any further regulatory steps which might be required to secure an appropriate degree of consumer protection.

22. The CBA for the proposal to abolish post-sale key features (paragraph 10.24 and Annex C, paragraph 7.1) makes no attempt to quantify the impact of the proposal on consumers. We recognise that the FSA is awaiting the results of consumer research in this area but, even so, we are surprised that the CBA does not contain even a qualitative assessment of the likely impact on consumers along the lines of that included for the impact on firms. Furthermore, this provision was originally introduced to ensure that consumers received the document directly from the product provider in case it was not supplied by the adviser. No attempt has been made to assess compliance with the provision of key features by advisers, nor to ascertain whether consumers retain copies given prior to completion of the contract.

Scope

23. The scope of the regime does not appear to be based on a systematic analysis of the risks faced by consumers. This may be due to the pressure to have a regime in place by N2 but the risk basis will need to be reviewed in the medium term.

Products

24. Distinctions are made in the draft Sourcebook between designated investment business, “packaged products” and other products, such as deposits, general insurance and pure protection long term insurance contracts (eg term assurance). It is not clear that these distinctions are based on an assessment of the risk of detriment arising. For example, the consumer protection basis for excluding some permanent health insurance and term assurance from the polarisation regime is unclear (paragraph 9.3, p49). Neither is it clear whether these distinctions will have a statutory basis under the FSMA or are at the FSA’s discretion. We recommend that the FSA and HM Treasury clarify whether the decision to limit application of the COB rules to deposits and general insurance (see eg polarisation and financial promotion rules) reflects a policy decision taken by the FSA or a legal constraint on the FSA which the new legislation will impose.

25. Meanwhile, we recommend that, where possible, COB requirements and the relevant requirements imposed by other bodies, such as the General Insurance Standards Council, the British Bankers Association and the Advertising Standards Authority are consistent.

26. Paragraph 4.9 states that the FSA presently has no plans to specify that contravention of a rule is *not* actionable by a private person who suffers loss as a consequence of the breach. The Panel supports this approach and would be concerned if it should change. We would expect pre-consultation on any proposal to move from this position and a clear analysis of the rationale for any change proposed.

Communications channels and methods

27. Guidance on the internet and other electronic media is set out in section 3.14 (pages 36&37 of CP45a Part III). This mainly addresses issues about the sequence in which information is accessed. It does not appear to indicate that the FSA has reviewed whether the COBS provisions are applicable to electronic media – for example how key features information can best be communicated through electronic media. This will need to be done as part of the first principles review.

28. Paragraph 7.6 and table 3.5R set out forms of communication which are exempt from the financial promotion requirements. These include individual one-off correspondence. Internet and other electronic technologies offer the potential for communications and offers to be tailored specifically to an individual in terms of products, price and other terms available. A communication could be an “invitation or inducement” (the definition of a financial promotion) addressed only to one person, but still be part of a financial promotion strategy. We recommend that such communications are brought explicitly within the scope of the financial promotion regime. In the present draft, it is not clear whether communications of this sort would be caught by the guidance on personalised mailshots “which in fact comprise the same or virtually the same material sent to a number of customers, without tailoring the material to the circumstances of the individual” (3.5.3G (2a), p8). This needs clarification. Other criteria may need to be found to enable correspondence such as suitability letters to be exempted without inappropriately excluding targeted promotional material.

29. It is also not clear from the draft Exemptions Order or the draft COBS whether exemptions from financial promotion rules for journalists apply to publications available exclusively through electronic media. If there is any anomaly here it is likely to be unsustainable as electronic media develop. We repeat the recommendation in our earlier response that the Government should assess the potential for consumer detriment arising

from advice given in newspapers before determining the final scope of the Exemptions Order.

Record keeping

30. The proposed provisions cut from 6 years to 3 years record keeping requirements relating to financial promotions and to advising on and selling products other than life and pensions products.

31. The difficulties faced by regulators and the industry in carrying out industry-wide reviews such as the pensions review because of poor record keeping highlight the need to reinforce the current requirements, not decrease them. In its December 1999 statement about endowment mortgages, the FSA recognised this problem, noting that “Record-keeping is generally inadequate and raises questions about the suitability of a significant proportion of sales”. The case for strengthening, or at least maintaining existing requirements is particularly strong because, as the CBA points out, there is no likelihood of any compliance cost benefit to the industry arising from the reduction.

32. We recommend that an evidential provision is added to the COBS rules on record keeping to the effect that failure to produce the required records will be treated as *prima facie* evidence of non-compliance. For example, if an IFA is unable to produce records which demonstrate that a fact find was properly carried out, the FSA will presume that the fact find was not properly conducted.

Supervising the regime

33. It is not clear to us how supervision teams are being prepared for the new regulatory regime or what exactly the implications of risk-based supervision will be, with its emphasis on themes and cross-industry issues. However, it seems likely that the new approach will involve fewer visits to individual institutions. A likely further change will be closer integration of the supervision of prudential and conduct of business requirements.

34. Elements of the draft Sourcebook suggest that these likely changes have not been fully taken into account in designing the new COBS regime. For example, the cost benefit analysis of reduction in record keeping requirements for financial promotions cites as justification the fact that records are of little value unless consumers make complaints or errors are identified and investigated, which rarely happen at present. Each of these points seems liable to change once supervision visits become less frequent - potentially gaps between visits will be longer and consumers might experience more errors if the discipline of regular checks is removed.
35. Supervisors need the skills to monitor the full range of COB rules effectively. The FSA will therefore need to put in place a strategy to ensure that supervision is carried out systematically and proactively and will need to ensure that its own training and competence arrangements are effective and up to date. The FSA will face risks to its statutory objectives if it does not do so.
36. For example, recent research we have commissioned has suggested that for those consumers who buy through sales channels which do not involve any face to face contact, financial promotions can be one of the main drivers in selecting a product. A common motivation for buying without face to face contact was mistrust of advisers, rather than a more positive reason, such as convenience. These consumers also expressed concern about the difficulty of identifying “the right questions to ask” about the product they eventually bought, making them ill-equipped to challenge the content of the financial promotion or consider the relative merits of one course of action against another. This leads to an environment in which the potential for mis-buying and mis-selling is high. It is therefore particularly important that the promotional material upon which these consumers rely complies with the COBS rules, and that this compliance is tested by the FSA. We think there is a case for the FSA to monitor

financial promotions much more pro-actively than previous regulators have in the past. (See our earlier comments in paragraph 13.)

37. The Panel's response to the proposed training and competence regime emphasised the need for the FSA to set benchmarks for the standards expected, for its own supervisors as well as the industry. The same issue arises in COBS. For example, COB 3.9.4R prohibits a firm from sending a direct offer financial promotion for an unregulated collective investment scheme, a derivative, or a warrant unless the firm "believes, on reasonable grounds, that the investment is likely to be suitable for the customer to whom the promotion is directed". The FSA should explain what criteria supervisors will use to make this judgement and on what basis the criteria have been established.

Annex

38. This Annex contains detailed points on the proposed COB Sourcebook.
39. Paragraph 4.19 – We question whether this timing will still be appropriate in the light of changes to the likely date of N2 and invite the FSA to set out a revised position at an early date. Since firms will have the new rules at the end of the year, while N2 is still a moveable feast, the 12 month transition period should not be linked to N2. There is a risk of consumer detriment arising from an unduly long transition period in two respects: first, consumers could be confused by continuing references to the predecessor regulators as well as the FSA, which could undermine the FSA’s consumer education work.
40. Paragraph 5.3 (1.3.1R – 1.3.3G) - The application of COBS to potentially regulated activities will need to be clear, particularly if the regime for long term care insurance and pre-paid funeral plans are changed.
41. Paragraph 8.6 – We are concerned that the suggestion made here that the terms of business may be dispersed among “any number of documents” as this is likely to make it extremely difficult for consumers to follow, particularly if amendments are sent out piecemeal.
42. Paragraph 8.8 – The period of 10 business days notice before a firm may conduct business on amended terms seems to us to be significantly too short.
43. Paragraph 9.3 – The rationale for excluding term assurances and permanent health products altogether from the scope of the polarisation rules rather than including them all is still unclear. The FSA should make clear what evidence it has to justify its conclusion that “there is nothing to suggest that such contracts have been wrongly sold” and, more importantly, explain why it is of the view that this will remain the case if these products are taken outside the polarisation requirements altogether.

- 44.Paragraph 9.5 – The rationale for not requiring firms to disclose their polarisation status in premises prior to the outcome of the review is unclear and should be explained more fully. This appears to remove an existing opportunity for raising consumer awareness at little cost. It also seems unnecessary to make this change now, before the outcome of the polarisation review is known and its implications assessed.
- 45.Paragraph 9.14 – we support the continuation of the “better than best advice” requirement.
- 46.Paragraph 10.7 – if production of the with-profits guide is discontinued it will be important that information about with-profits products is available in an alternative form. Even if consumers make little use of the information directly at the moment they should be able to use it if they wish and commentators and advisors should certainly have access to the information to ensure that it can reach other consumers indirectly.
- 47.Paragraph 10.22 – as noted above, we have concerns about making changes to the key features regime before the FSA’s programme of research is completed. The argument in this paragraph takes no account of the potential impact of shifting from firms to consumers the responsibility for ensuring that the consumer has full information about the product purchased. This should be taken into account in any cost benefit analysis of removing the requirement for post-sales key features.
- 48.Paragraph 10.24 – it seems to us to be ill-judged that the FSA should put these proposals out to consultation without having any feel at all for the impact on consumers.
- 49.Paragraph 13.35 – The FSA should set out what implications this proposal will have for consumers and how the 6 year time horizon was arrived at. We disagree that there is a good case for this provision. In practice, it is unlikely that consumers will get a choice as to whether this provision will apply, as firms will build it into their standard terms and conditions. This raises the question of whether this is a fair contract term. Further, firms

may have a very limited view of what constitutes “untraceable” which could act to the consumer’s disadvantage.

50.Paragraph 13.57 – We support the analysis contained in the CBA.

51.3.8.18G and glossary explanation on CP45a Part III Annex A p40 – it is not clear what forms of communication available at present will constitute “real time communications” – for example are e-mails or text messages delivered via mobile phone included?

52.5.1.18G – This raises questions about the relationship between the rules and guidance. It is not clear that the qualification in the guidance that “image” promotion should in all cases be exempt is justified. Such image promotion plays an important part in shaping consumers’ awareness of companies and their services and the guidance removes an opportunity for polarisation status to form part of that perception.

Who is on the Panel?

Barbara Saunders (Chairman)

Barbara is a public interest member of the PIA Board. She is an independent consumer consultant and past Chairman of the Council of the Insurance Ombudsman Bureau. Among other public and professional appointments she is a Non-Executive Director of the West Hertfordshire Hospitals NHS Trust and a member of the Architects Registration Board.

Colin Brown (Vice Chairman)

Colin is an independent consultant specialising in consumer affairs. Previously Deputy Director of Research at Consumers' Association and Senior Fellow at the Policy Studies Institute, he has over 20 years' experience of social and consumer research.

Jean Gaffin

Jean was for 7 years until December 1999 Chairman of the Advisory Committee on Telecommunications for Disabled and Elderly People that provides advice to the telecommunications regulator, OFTEL, and is a Non-Executive Director of Harrow & Hillingdon Healthcare NHS Trust. She has extensive experience of working on behalf of vulnerable consumers. Previous positions include: the Executive Director of the National Council for Hospice and Palliative Care Services and Chief Executive of Arthritis Care.

Yvonne Gallacher

Yvonne is Chief Executive of Money Advice Scotland, which was set up by the Scottish Consumer Council. She has over 10 years experience of consumer credit/money advice issues and of working with vulnerable consumers in a variety of roles, including debt counsellor, trainer and manager. She is Co-Director and Secretary of the Government funded Lead Body for Advice, Guidance, Counselling & Psychotherapy (CAMPAG). Yvonne is a member of the Scottish Consumer Council.

Joan Harbison

Joan is Chief Commissioner of the Equality Commission for Northern Ireland. She has been Chair of the Commission for Racial Equality for Northern Ireland since its inception in 1997 and is a former Chairman and member of the Executive Committee of the Northern Ireland Association of Citizens' Advice Bureaux. She has held a number of public appointments including being Vice Chairman of the Eastern Health and Social Services Board and the Northern Ireland Standing Advisory Commission on Human Rights and former member of the Human Fertilisation and Embryology Authority.

Gerald Lanchin

Gerry is a Vice President of the National Federation of Consumer Groups. He is a former Under Secretary of the Consumer Affairs Division of the Department of Trade and Industry and author of "Government and the Consumer". His involvement in consumer protection includes being a former Council Member of Consumers' Association and of Consumer Congress Committee. He was the first chairman of the Direct Mail Services Standards Board and a member of the Data Protection Tribunal for 10 years.

Nick Pearson

Nick is the National Money Advice Co-ordinator for the Federation of Independent Advice Centres. A career spent in advice organisations including the National Association of Citizens' Advice Bureaux where he was manager of the Money Advice Support Unit, he has particular experience of credit, debt and personal finance issues and of working with vulnerable consumers.

Richard Smethurst

Richard is Provost of Worcester College, Oxford University; he chairs the Training Standards Panel of IMRO, of which he is a non-executive Director. He has served as an economic adviser in Whitehall, and the Monopolies and Mergers Commission, where he was Deputy Chairman. Richard lectures widely on financial and economic topics to businessmen and adult education groups. He is President of the National Institute of Adult Continuing Education.

Jane Vass

Jane is an independent consumer researcher specialising in financial services. She was previously Head of the Financial and Economic Research Group at Consumers' Association and is still author and editor of a number of Consumers' Association publications in addition to other research, including work for the National Consumer Council. Her current committee memberships include: Council of the Ombudsman for Estate Agents, the Inland Revenue Tax Law Rewrite Project Consultative Committee, the PIA Training Advisory Group and the FSA Training Advisory Panel.

Dave Watts

Dave is a partner in a media business which is involved in publishing, editing and journalism - personal finance plays a large part in this. He is a former editor of "Which?" and "Money Which?" and former Assistant Director of Consumers' Association. He was also a policyholder representative on the Insurance Brokers Registration Council for nine years.

How to contact the Panel

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