

Financial Services Authority

**Conduct of Business
sourcebook (COBS)
post-implementation
review: final statement
on findings**

March 2010

Contents

1	Introduction	2
2	General findings	5
3	Financial promotions	10
4	Suitability	15
5	Appropriateness	20
6	Product information disclosure	23

1 Introduction

Background

1. Since November 2007, we have undertaken a two-year post-implementation review (PIR) of the rule changes for retail investment business introduced by the Conduct of Business Sourcebook (COBS). COBS came into effect in November 2007, partly as an element of our implementation of the Markets in Financial Instruments Directive (MiFID), and partly to make it more consistent with our more outcomes-focused regulatory approach.
2. In addition to a general overview of the impact of the COBS changes¹, through the PIR we have looked at firms' responses to the following priority changes for retail business:
 - the new regime for financial promotions and other communications;
 - the reformulated suitability regime;
 - the new appropriateness obligation for a range of 'non-advised' services; and
 - changes concerning the disclosure and provision of product information (including projections and information provided through disclosures such as product risk warnings), through a simplified prospectus or a key features document (KFD).
3. We communicated interim findings from our review in December 2008.² That statement set out our high-level initial findings about how firms had responded to the rule changes, to the extent that they were identifiable up to the end of November 2008.
4. Many of the small firms we surveyed in 2008 had done what was necessary to implement retail COBS, but had not sought to take full advantage of the greater flexibility to align intended regulatory outcomes with legitimate business practices. The changes also coincided with the market downturn and economic crisis, so the climate for innovation has not been conducive to large-scale change, and firms have taken fewer opportunities than they may have taken in a less challenging environment.

1 Our COBS PIR did not cover all areas of COBS. For example, it did not cover non-retail areas like investment research or the specialist regimes, or the COBS chapters on dealing and managing, client categorisation, pensions and with-profits. Also, because our Retail Distribution Review (RDR) proposals will seek to change the way in which advisers are required to disclose information, we did not consider it appropriate to continue to assess firm compliance with the current COBS 6 rules (Information about the firm, its services and remuneration) as part of the COBS PIR.

2 FSA *Conduct of Business sourcebook (COBS) post-implementation review: 2008 statement on interim findings* (December 2008).

5. As the 2008/09 FSA Annual Report confirmed, the review continued in 2009³ by seeking to measure the impact of the COBS regime on consumer outcomes and the behaviour of firms, and we continued to work with firms and other stakeholders.
6. This statement sets out our findings, but does not seek to establish direct causation between the introduction of COBS and those impacts we have identified and assessed in all respects. This is because, since COBS implementation, we have increasingly found that some new and emerging regulatory initiatives (and continuing market developments) have influenced the COBS PIR project scope, thereby limiting the extent to which we can legitimately point to certain outcomes as a measure of the effect of the COBS changes alone.
7. Other initiatives that have gathered momentum since COBS implementation include, for example, our review of KFDs, our emphasis on delivering good consumer outcomes through embedding Treating Customers Fairly (TCF), and more recently our new operating model to address conduct risks (including our increased use of ‘outcomes testing’ – see Chapter 4). We have also seen that future regulatory changes resulting from our Retail Distribution Review (RDR) proposals and various European Union (EU) initiatives⁴, for example, have influenced firms’ appetites to make some discretionary changes allowed by COBS – that is, firms were waiting to see how various policy proposals develop before making more change than strictly necessary.
8. Also, we are mindful of the fact that COBS is now very much a part of our normal supervisory and policy activity, and is itself the baseline for further changes. As one industry body pointed out in feedback received in 2009, given the time that has passed since the introduction of COBS (and the implementation of MiFID), *‘firms now treat [the COBS/MiFID-derived rules] as business as usual. Most [firms] are, if anything, looking to future developments, [for example] in terms of the AIFM⁵ directive etc ...’*.

Structure of this paper

9. Chapter 2 sets out our findings on the main general aspects of the impact of the COBS changes - broadly confirming our 2008 interim findings. Chapters 3, 4, 5 and 6 set out our further and more detailed findings on firms’ responses to the following COBS changes respectively:
 - financial promotions;
 - suitability;
 - appropriateness; and
 - product information disclosure.

3 In addition to the data gathered in 2008, this statement of findings is based on further data arising from: a targeted survey of large investment firms; a review of additional product documentation obtained from other relevant FSA work and direct from firms; and views solicited from a range of industry associations and other stakeholders.

4 For example, the EU is developing proposals to extend relevant MiFID standards to a wider range of ‘packaged retail investment products’ (PRIPs).

5 Alternative Investment Fund Managers Directive.

Follow-up to the review

10. As indicated above, the COBS changes that came into effect in November 2007 (along with subsequent refinements to them) are now an integral element in our day-to-day regulation of firms' designated investment business.
11. Where we have identified issues with the COBS rules (for example, financial promotions), we will be considering these for action and any resulting proposals for specific improvements will be progressed through our normal consultation processes (likely to be in a quarterly consultation paper (QCP)). EU and other international influences will also be reflected in future proposals for changes to COBS as necessary, in the normal way. Where we identify desirable changes to EU requirements, we will be raising these in the appropriate discussions.
12. We will continue to review our COBS webpages⁶ and update them when appropriate. The industry has indicated that they find this kind of FSA feedback very useful, not least in getting a sense of the FSA's assessment of specific responses from firms to changed requirements (for example, through our identification of good practice).

⁶ www.fsa.gov.uk/Pages/Doing/Regulated/newcob, which includes several case studies, questions and answers, and examples of good and bad practice.

2 General findings

COBS implementation experience

1. In 2008, we surveyed a sample of retail intermediaries on their COBS implementation experience. The majority of those smaller firms found that COBS was more accessible (easier to use and to understand, as we had intended) and many acknowledged that COBS allows them greater discretion to review their approaches to compliance. Nearly all of these firms indicated that they had reviewed their processes since the introduction of COBS to identify where changes might be required, but had not necessarily changed their procedures as a result. This was either because they concluded that no change was necessary, or because they decided to defer any change beyond what was strictly necessary in order to remain compliant. These results were echoed in our 2009 findings.
2. In 2009, we surveyed a sample of larger firms on their COBS experience as part of our final effort on data gathering for the post-implementation review.⁷ The majority of those firms indicated that there were no problems when implementing and adapting to the COBS changes. The rest indicated that they had faced some challenges, but none said that the changes were difficult to implement.
3. Trade association feedback throughout our two-year review indicated that COBS is generally regarded as being easier to follow than the pre-2007 rules. And, although differing rules for MiFID and non-MiFID business has added some complexity, there was general support for our case-by-case approach to the implementation of MiFID requirements to non-MiFID firms and business (for example, extending the MiFID suitability requirements to advice on non-scope products, but not applying the appropriateness test to life and pensions products).

⁷ We identified a sample of large firms using annual spending on financial advertising as the selector (this data was taken from Ebiquity as at 8 October 2009). Other firms volunteered information through their trade associations. The total sample was ten firms, which included fund managers, large banking groups, and life insurers.

Use of discretion to achieve regulatory outcomes

4. In spite of some indication of general support for more outcomes-focused regulation, over the past two years one of the main themes to emerge from industry feedback – with regard to the increased flexibility that COBS was intended to provide – was that, in some circumstances, the lack of prescription made the decision on what needs to be done more challenging for firms.
5. Having regard to our outcomes-focused approach to regulation, we took the opportunity offered by the requirement to implement MiFID to review the COBS sourcebook and to simplify it, where possible. In doing this, we sought to streamline or remove non-essential provisions from COBS – relying more on principles and outcome-focused rules, rather than prescriptive rules and guidance. We said that this was part of a continuing process, requiring significant behavioural change for both firms and the FSA: that is, we expect firms to consider how best to achieve our intended regulatory outcomes. In helping firms to meet our expectations, we said we would provide a greater range of clearly sign-posted information outside the Handbook to assist them in planning their business processes and controls with confidence.
6. We have acknowledged that in a more outcomes-focused regulatory environment compliance decisions may be more demanding, but, as evidenced through our subsequent messages and initiatives – including our recent statements on more intensive supervision – we remain committed to promoting more outcomes-focused behaviour, not least to secure better outcomes (and benefits) for consumers.

Provision of COBS supporting materials and guidance

7. We have noted that around the time of COBS implementation (November 2007) there were limited practical examples of how we expected to see the new regime applied, but we have developed our supporting material on priority COBS areas over the past two years. Since November 2007, we have updated our COBS webpages with supporting material and non-Handbook guidance. Where we identified examples of good and poor practice through our focused reviews of aspects of COBS, we included these on our website. This additional COBS supporting material is also central to the commitment we made to firms when we introduced more outcomes-focused regulation, which was that we would provide greater clarity about our expectations for those tasked with understanding and applying rules in their firms.⁸
8. The majority of retail firms we surveyed in 2008, and all of the larger firms surveyed in 2009, indicated to us that the range of COBS supporting material on the COBS webpages was helpful.
9. The main points made by firms in 2009 regarding non-Handbook guidance were that our supervisory expectation appears to be that firms should meet the standards set out in guidance, that we do not take account of the appropriateness and proportionality of this guidance to individual firms, and that this approach might lead to the inadvertent creation of new standards with which industry must comply.

⁸ In August 2009, we re-stated our approach to giving guidance and the status of that guidance. See www.fsa.gov.uk/pages/Library/Other_publications/Miscellaneous/2009/guidance.shtml.

10. Our response to these points is that the intention behind providing non-Handbook guidance and supporting material is to illustrate ways (but not the only ways) in which firms can comply with the relevant rules. Guidance and supporting material do not set out the minimum standard of conduct needed to comply with a rule, nor is there any presumption that departing from guidance indicates a breach of a rule. If a firm has complied with the Principles and other rules, then it does not matter whether it has also complied with other material the FSA has issued. On the point about considering the position of individual firms, we have increasingly focused our supervisory and enforcement tools (and associated training and development of our staff) on looking at our Principles and the outcomes they describe, allowing supervisors and others to understand better how individual firms are exercising discretion in how they achieve outcomes.
11. Feedback in 2009 also included the suggestion that we refer in COBS to any non-Handbook guidance and supporting material, where applicable. We do not generally cross-refer to such material because, as stated above, supporting material (such as examples of good and bad practice) demonstrates some, but not the only, ways that firms may decide to comply with a certain rule. However, we are keeping this matter under review because we are aware of industry concerns about access to the Handbook and related supporting materials.

Cost of implementing COBS

12. A formal ex-post analysis of the costs and benefits of the retail COBS changes was not included in the scope of the post-implementation review. Nevertheless, during 2008 (May-August), we commissioned LECG Ltd to make an initial assessment of the impact of principles-based regulation (by measuring any initial change in firms' regulatory costs, and analysing the related benefits, of changes introduced by certain regulatory initiatives – including COBS, TCF, and changes in supervisory and enforcement style).
13. The report⁹ indicated that the changes observed as a result of COBS were limited. It also stated that its COBS findings were broadly in line with those reported in our December 2008 interim findings statement.
14. In our 2008 interim statement, we noted that for the majority of the smaller firms we surveyed, the overall burden of the COBS changes on their businesses was 'minor' and their industry associations' feedback echoed this view. Most of those firms said that they had incurred some one-off costs, at least in considering the need for change, making any changes and providing necessary training. One-off costs also arose from re-printing internal and client-facing documentation and policies. And, as we expected, some COBS changes also resulted in some specific systems changes, which proved more costly.

⁹ LECG Ltd *The Regulation of Retail Investment Products: An Initial Assessment of the Impact of Recent Changes* (27 May 2009).

15. In our 2009 large firm survey, the majority of firms indicated that there was either a ‘moderate’ or ‘no significant’ impact on their businesses from both COBS and MiFID changes. Feedback gathered in 2009 about the costs firms may have incurred as a direct result of implementing COBS varied widely – from not being able to attribute any costs to COBS changes, or the costs being absorbed within business as usual; through one-off consultancy costs or direct one-off implementation costs; to ‘several hundred thousand pounds’ (unspecified).
16. Industry body feedback indicated that constraints imposed by legacy systems meant that the costs of making some changes immediately would have been prohibitive, as they may have outweighed any benefits. As a result, opportunities for improvements would have been logged until such time that they could be delivered with other enhancements, thereby benefitting from economies of scale. Also, where business groups have both MiFID and non-MiFID scope firms, they are likely to have considered the best solution for their business as a whole. In some instances, in the interests of cost and efficiency, this may have meant applying the higher standard to both scope and non-scope business (for example, in the area of projections, where some firms may have already invested heavily in existing projection systems for non-MiFID business).

Facilitating appropriate consumer outcomes

17. Some feedback has suggested that although consumers may have benefitted to a certain extent from the additional protections introduced by MiFID, and from a greater degree of disclosure in some areas, it is likely that the effect of the changes brought about by MiFID implementation would have been more tangible for consumers in those other EU countries where the conduct of business regime may not have been as established or developed as in the UK.
18. Nevertheless, we have identified examples of changes firms have made to meet the revised COBS requirements and these are detailed in the following chapters. Furthermore, comments we received from the firms we surveyed in 2009 on benefits (potential or actual) identified for both firms and consumers included:
 - A key advantage of outcomes-focused regulation is the flexibility to deliver compliance solutions that best meet customer needs. COBS gives firms the opportunity to communicate with customers in a way that their own research indicates customers understand, rather than by following prescriptive rules.
 - For financial promotions, moving to a more outcomes-focused regime provides opportunities to tailor products and services more closely to the customers’ needs, and to create more innovative advertising.
 - Removal of the requirement to issue post-sale key features illustrations and cancellation reminder notices is a cost saving for firms.

- Simplification of customer communications enables the production of shorter, more customer-focused literature.
 - Clearer COBS supporting material facilitates easier understanding and application of the rules, thereby increasing professionalism.
19. We hope that the realisation of benefits will become more apparent over time as firms become more comfortable with the parameters of our more outcomes-focused regulatory approach and the opportunities afforded by COBS to deliver these outcomes.

3 Financial promotions

Background

1. The 2008 interim findings for the review of COBS 4 (financial promotions) indicated, generally, that there was minimal change in firms' behaviour. While standards had been maintained, firms had not taken full advantage of the flexibility provided in COBS 4.
2. Our 2009 review reiterates that there has not been radical change. Generally, firms felt that they were already meeting the required standards and so made few changes, if any. This is because the COBS 4 requirements – while being more high level – have substantially the same intended outcomes as the previous COB rules and do not impose additional regulatory requirements for promotions to retail clients.
3. The majority of large firms surveyed said that the COBS 4 rules were either 'somewhat' or 'much' easier to understand, although a substantial minority described them as the 'same'.
4. In spite of this, the feedback received over the past two years, and our ongoing monitoring, indicates that changes are occurring. These changes are not revolutionary, but are aimed at improving consumer understanding, and therefore consumer outcomes, as a result of COBS and other regulatory impacts (such as the TCF initiative). The changes include: a greater interaction between marketing and compliance functions; small changes to the wording of risk warnings so that the risks are more meaningful and relevant to the specific product and target market; and tailoring, and in some cases testing, the tone and language within promotions so that it is better understood by those likely to receive it. These changes help reduce information asymmetry.
5. We have found that the high-level COBS provisions (including the overall requirement for firms to disclose sufficient information that does not disguise or diminish important information or components, and that does not emphasise potential benefits without also giving a fair and prominent indication of any relevant risks) are capable of providing an appropriate level of consumer protection. We have not identified any significant concerns in this regard as a result of the new regime. It is worth noting that while some thematic work has highlighted some failings (such as the structured

product promotional material review), these failings are not a result of moving to high-level rules. On the whole, we have some evidence that the standards of compliance with our rules have not decreased overall, but have increased since the introduction of COBS.¹⁰

6. While COBS has provided more discretion for firms, feedback suggested some firms do not have the confidence to take advantage of the opportunities provided. Some firms have been cautious, unwilling to innovate and to adopt new approaches, especially in an uncertain economic climate or where they were unsure of our regulatory expectations.
7. More specifically, our financial promotions review sought to identify whether certain general intended outcomes had been achieved. We discuss some of these outcomes and our findings below.

Approach to preparing financial promotions

8. The responses to our COBS 2008 surveys indicated that many firms had changed the way they prepare financial promotions – for example, earlier engagement between marketing and compliance, increased senior management involvement and increased management information. This indicated firms had increased their focus on outcomes and were better aligning compliance with other business functions.
9. The feedback we received during 2009 supports our earlier findings that firms have reviewed and, where relevant, changed their approach to preparing financial promotions to achieve a greater focus on producing clear, fair and not misleading promotions, rather than relying on compliance with detailed requirements. For example, improving the information provided about product features helps reduce information asymmetry and is beneficial to consumers.
10. The greater interaction between marketing and compliance functions we have noted indicates how many firms have reviewed their preparation and sign-off processes, making changes that lead to improved consumer outcomes.

Direct offer financial promotions

11. The COBS approach to direct-offer financial promotions provides firms with greater scope than the pre-2007 rules to vary the timing of providing the required information – so firms do not need to provide all the required information at the same time. For example, a financial promotion could be sent to a consumer, with the full information pack sent after the consumer signals an interest in proceeding. The

10 This is based on the results of a three-year independent assessment of financial promotion compliance standards, undertaken by an external consultancy, that examined promotions from 2006 to 2009 and showed a year-on-year increase in compliance with our standards. See: www.fsa.gov.uk/Pages/Doing/Regulated/Promo/independent_compliance/index.shtml.

cost-benefit analysis (CBA) in Consultation Paper CP06/20¹¹ suggested there might be some potential consumer detriment where firms provided this information significantly earlier or later in the process, thereby limiting its impact on consumers. However, this potential detriment is mitigated by the high-level requirement for firms to provide sufficient information to enable a consumer to make an informed investment decision.

12. In CP06/20, we suggested firms would not often take advantage of this flexibility, preferring to incorporate all information within the initial financial promotion to avoid erecting a further barrier between the client and the transaction. Our review during 2008 and 2009 indicated there had been little take-up by firms of this flexibility and that the direct offer process remains largely unchanged.

Risk warnings

13. Providing risk warnings that are tailored and appropriate to the nature of the product can result in consumers having a greater understanding of the risks involved in a particular product or service.
14. We have seen evidence of firms replacing the old COB risk warnings with revised warnings. Many of the changes we have seen have been subtle or small, such as the replacement of a single word or redrafting the order of a sentence. Generally speaking, risk warnings have been more appropriate to the nature of the product and the audience likely to receive the promotion. We have also seen evidence of firms tailoring the risk warnings to the product being promoted and applying a tone and language that is more suitable for the audience likely to receive the promotion.
15. Unfortunately, we continue to see some use of redundant risk warnings in promotions – the main culprit is the inclusion of a past performance warning where no past performance information has been provided in the promotion.

Past performance

16. In CP06/20, we anticipated that past performance was likely to be one area where firms would take advantage of the greater flexibility in COBS to adjust their practice. The concern was that firms would begin to use past performance data more aggressively in promotions, possibly leading to consumer detriment where:
 - certain presentations may encourage unrealistic expectations of future performance;
 - non-standardised information could make comparisons more difficult; and
 - less explicit requirements for past performance risk warnings may diminish their importance.

So, our COBS 4 guidance confirmed that presenting past performance data in a similar format to the rules previously in COB would satisfy the higher-level COBS rules.

11 FSA CP06/20 *Financial promotions and other communications* (October 2006).

17. We have not seen evidence of firms using past performance data more aggressively in promotions to exploit the additional flexibility granted under MiFID. However, since the introduction of COBS, our ongoing monitoring has found that fewer promotions have focused on past performance. Given ongoing market conditions, this is not surprising.
18. Where we have seen firms apply the new flexibility, this has been mainly through illustrating past performance using graphs rather than the traditional past performance table. We have noted that non-standardised past performance information can make comparisons more difficult. However, prescribing a past performance format that is super-equivalent to MiFID would have led to a significant possibility of regulatory arbitrage (if we had more detailed rules than other EU states).
19. The independent financial promotion assessment referred to in paragraph 5 above identified one promotion in particular where we were concerned about the presentation of the past performance information. The firm used a graph to illustrate past performance and had technically complied with the past performance rules. However, the past performance was presented in descending years (reading left to right) providing the misleading impression that performance had improved – when in fact the performance of the fund had declined. The misleading impression created by the graph did not meet the purpose of the past performance rules or the high-level ‘fair, clear and not misleading’ rule.
20. Generally, we have we found that standards of consumer protection in relation to the presentation of past performance have at least been maintained.

Targeting of financial promotions

21. COBS 4 enables promotions to be tailored more closely to the needs of the group to whom the promotion is directed. We no longer require firms to provide specific information in a certain format, but we require firms to provide information that is sufficient for, and presented in a way that is likely to be understood by, the average member of the audience. Firms now have both the responsibility for and the discretion over what information they provide to customers and in what format.
22. The intended outcome of this increased flexibility is that firms create informative promotions that are appropriate for the needs of the consumers to whom they are being directed and for the nature of the product.
23. We have seen evidence of improved targeting of financial promotions by firms. For example, we have seen firms providing more appropriate information to their target market by adapting the tone and language used in the promotion depending on whether it is directed at either retail or professional clients.
24. The feedback we received also indicated that some firms are testing consumers’ understanding of promotions and the key terms used within them. We welcome such testing as it provides firms with a greater appreciation of how their target market understands and evaluates the product or service being promoted.

Small firms

25. Some firms, particularly small firms, have indicated a lack of awareness of new financial promotions material. In addition to the information contained on the COBS webpages, our dedicated financial promotions webpages¹² contain all our financial promotions communications, highlighting any new or updated communications. We hope to address any continuing lack of awareness by referencing this material in our communications with firms. We include new financial promotions communications within our monthly Regulation Roundup, which we email to all regulated small firms. Individuals at small firms can also receive their own copy by completing an online subscription form.¹³

Follow-up

26. Through our ongoing supervisory work we will continue to monitor the use of past performance information in financial promotions to check whether the standards of consumer protection are maintained.
27. We will be consulting (in a QCP) on making a few minor changes to COBS 4 to improve the clarity of a number of provisions. These changes have been driven by some of the suggestions received from industry stakeholders in response to our request for feedback on COBS.

12 www.fsa.gov.uk/Pages/Doing/Regulated/Promo/index.shtml.

13 www.fsa.gov.uk/smallfirms/resources/regulation_roundup/register.shtml.

4 Suitability

Background

1. As reported in December 2008, key points from the interim phase of our post-implementation review of COBS 9 (suitability) were that:
 - firms believed the reformulated suitability standards were more coherent and better articulated than those in the old COB, and that this may promote better consumer outcomes¹⁴;
 - firms generally still supported our decision to apply one (MiFID-driven) set of revised suitability requirements in COBS to advisers selling all types of designated investment products; and
 - there was some evidence of investment firms having changed documentation and processes, though we had minimal evidence of the *effects* of these changes at that stage, in terms of the outcomes for consumers.
2. We found some good examples of positive change from the small sample of larger investment firms that we reviewed in the first year of our post-implementation review. These were particularly in respect of private clients.
3. However, the picture for retail intermediaries remained mixed: those firms that had previously demonstrated good standards of fact-finding and explaining recommendations in their suitability letters/reports continued to do so, but those with poorer standards had not necessarily improved.
4. Evidence indicated that around 50% of the firms we surveyed in 2008 had made changes to the format/approach of their suitability reports since November 2007. However, with very few exceptions, the sample documentation reviewed did not demonstrate the degree of change and improvement that this figure would imply, in terms of clearer, more targeted presentation of information. We were disappointed to see that more firms had not used the greater flexibility in COBS as an opportunity to improve their suitability reports.¹⁵

14 A targeted survey of larger firms about COBS carried out in 2009 showed most respondents seeing COBS 9 as 'somewhat easier' to understand than old COB, with others seeing it as 'the same' in this respect.

15 Our investigation into the sale of Lehman-backed structured investment products (see paragraphs 9 and 10 of this chapter) found a widespread failure by firms sampled to disclose counterparty risk adequately to customers in their suitability reports, as well as instances of factually incorrect information within suitability reports.

5. Our findings underlined the need for us to continue to reinforce messages around quality of advice processes, and we have sought to do this through publications (for example, by using factsheets), speeches and our internal prioritisation of risk (see below).
6. We did not identify significant quantifiable benefits for ‘professional’ clients as a result of the extension of detailed suitability requirements to cover this category of client. However, discussions with firms and their representatives suggested that firms may be applying a greater discipline in their processes for investment advice and portfolio management for professional clients, because of MiFID implementation in this area. We suggested that if the COBS changes had promoted greater discipline around client assessments and clarification of client objectives and circumstances, this could produce benefits for these clients.

Subsequent developments

7. Since our December 2008 interim statement, we have made progress on a number of specific initiatives directly relevant to our suitability regime for designated investment business. We explain some of these below. We expect the findings of this ongoing work (and additional initiatives), and the supervisory attention that the work demonstrates, to inform our assessment of the effectiveness of our requirements in this area and any need for future change.

Outcomes testing

8. As part of our work to assess conduct risks, we have developed a programme to enable us to test consumer outcomes in a number of advisory scenarios. As explained in public documents, our approach to this outcomes testing work involves:
 - the preparation of outcomes testing ‘toolkits’ identifying risks, issues, questions and points for focused attention in looking at the quality and the suitability of a firm’s advice/service and assessing whether suitable outcomes seem likely to have been delivered for consumers;
 - visits to firms and file reviews;
 - analysis of firms’ internal management information, and other available data; and
 - specific follow-up as necessary.
9. The findings of this testing will inform our overall assessment of the quality and suitability of advice being provided by firms in the selected areas of advice. We have already published some findings - for example, we published a report in December 2008 on the findings of our outcomes testing on pension switching; and, in October 2009, we published our findings on sales of Lehman-backed structured investment products. In both cases, we also published the templates we used in the exercise to assess the quality and suitability of the advice (partly to enable firms to use these internally themselves, if they wished).

10. In the Lehman work, we found significant levels of unsuitable advice and substantial systems and controls failings in nine of the 11 advisory firms assessed.¹⁶ As a result, we referred three firms to our Enforcement Division for investigation and asked a further seven to undertake past business reviews. The report of our findings confirmed our standards for suitability of advice, provided examples of good and poor practice, and set out our expectations in respect of all structured investment products, not just those that were backed by Lehman Brothers.¹⁷ We said that we expected all firms advising customers in this area to take note of our findings and to take action as necessary and we committed to undertake follow-up assessments in the course of 2010 to ensure that they meet our standards and expectations.

Retail Distribution Review

11. In 2009, we published proposals to implement the findings of our RDR. One of the main objectives of the RDR exercise is to improve the quality of investment advice being provided to consumers, including its suitability. Key proposals include new requirements on the scope and status of advice and how it is presented to clients, which will also have a bearing on the standards of research and analysis underpinning recommendations, and the scope of instruments that must be considered. Proposals also cover the expertise, professionalism, analysis skills and explanation that underpin personal recommendations and other investment advisory services. Among other things, we intend that the greater focus on advisers' application of higher standards of knowledge, skills and expertise should improve not only the quality of advice provided¹⁸, but also the quality of suitability reports and other client communications where we have identified scope for improvement.

Product sales data and complaints data trends

12. We continue to monitor product sales data submitted by firms, to identify and analyse trends that may have a bearing on our view of the range of products being sold in the market. However, given market conditions over the past two years, it is not possible to draw any reliable conclusions (positive or negative) from the possible disaggregated effects of COBS regulatory change on product sales.
13. We also continue to consider how our suitability requirements may affect the volume and nature of complaints being made by consumers about investment advice and the suitability of personal recommendations. We have access to complaints data submitted to us by individual firms, which covers advice, and data published by the Financial Ombudsman Service (FOS).

16 The sample broadly reflected the population of firms that had given advice on these products. It included IFAs with national coverage, networks, and the banking sector.

17 Key reasons for unsuitable advice were:

- the recommendation failed to meet the customer's needs and circumstances;
- the recommended product exposed the customer to an inappropriate level of risk, including over-concentration of assets in a single product or product type (that is, there was failure to diversify the customer's assets); and
- the recommendation failed to meet the customer's tax needs.

18 Our investigation into the sales of Lehman-backed structured investment products evidenced failings in advisers' understanding of products which contributed to the risk of unsuitable recommendations.

14. Again, however, market conditions have complicated analysis of complaints data submitted by firms in the period 2006-2009.¹⁹ For example, falls in complaints about misleading advice between 2007 and 2008 (in a majority of firms) coincide with falls in transaction volumes influenced by market conditions, so no direct link to improved standards/controls within firms can be drawn. In some cases, there may also be a time lag between the sale and the complaint being made. Where some firms have experienced an increase in complaints about misleading advice, this may be influenced by poor performance of investments in the particular market conditions, rather than the inherent unsuitability of recommendations.
15. In its Annual Review of the year ended 31 March 2009, the FOS commented that it is still receiving a disproportionate number of stock-broking complaints about the sale of smaller-capitalisation shares – an area clearly susceptible to high-pressure selling. This is one aspect of unsuitable advice that we continue to focus on. A number of firms have used high-pressure selling techniques, particularly aimed at targeting vulnerable consumers by recommending unsuitable products and investments that fail to meet the customers’ needs, understanding, risk appetite, and what they can sensibly afford. This focus has already resulted in a number of enforcement cases. High-pressure selling risks will remain an area of ongoing FSA attention.

Consumer research

16. Notwithstanding the findings described above, consumer research carried out for the FSA during February 2009²⁰ found fairly consistent high levels of consumer confidence in the suitability of financial advice consumers had sought from financial advisers and banks/building societies, compared to 2008. These levels were: 91% for financial advisers (92% in 2008) and 86% for banks/building societies (88% in 2008).

Other future developments that may have a bearing on the suitability regime

17. In April 2009, the European Commission published a Communication signalling its intention to develop detailed proposals to extend relevant MiFID standards to ‘packaged retail investment products’ (PRIPs). Although COBS 9 already applies to all designated investments, EU changes could result in changes to the application and some detail of our (MiFID and IMD²¹-based) suitability requirements. This work may be complemented by a review of other aspects of the MiFID regime.

19 In October 2009, we also published aggregated data about the complaints received by firms from their customers for the period H1 2006 to H1 2009. See www.fsa.gov.uk/Pages/Library/Other_publications/commentary/index.shtml.

20 FSA consumer research, no: 80 *Consumer awareness of the FSA and financial regulation* (October 2009); fieldwork carried out by TNS with a sample of 1,997 consumers. See www.fsa.gov.uk/pubs/consumer-research/crpr80.pdf.

21 Insurance Mediation Directive.

18. The Committee of European Securities Regulators (CESR) is also undertaking work (a consultation exercise was undertaken in Q4 2009) to look at how Member States have implemented and interpreted the MiFID definition of investment advice. The review of the IMD is also relevant because COBS 9 integrates IMD requirements in respect of advice and the statement of demands and needs for advised sales of investment life policies. Other international work on national regimes for suitable advice could also have a bearing on our approach to suitable investment advice.

Follow-up

19. Regardless of future external influences, our post-implementation review and comments from stakeholders has led us to identify a few potential specific changes to the requirements in COBS 9. Some of these relate to our requirements for suitability reports. One issue, for example, is whether a suitability report should be mandatory for a wider range of financial instruments than currently required under COBS 9.4. Instruments such as structured investment products (where they are not already covered), unregulated collective investment schemes, contracts for differences and other derivatives, when recommended to retail clients, may be candidates for such an extension.
20. However, given that these few points may be covered by future EU work, we do not propose to publish specific proposals for change at this stage. We will keep this under review and publish any necessary proposals in the future.

5 Appropriateness

Background

1. In our 2008 interim report, we commented that, since the appropriateness test introduced by MiFID had no direct precedent in our previous investment conduct of business rules, data on its effects and any changes in consumer outcomes were inconclusive after only a year of its operation.
2. However, nearly all of the firms we had reviewed in the first year of our post-implementation review had made changes to respond to the intended outcomes of the appropriateness requirements, and we found some good examples of specific responses and approaches to implementation. In January 2009, we published a factsheet with examples of good practice.²²
3. We said that we had already found some evidence of potential benefits to vulnerable consumers, especially in terms of helping to promote client awareness of risks associated with more complex products. These benefits resulted from a better highlighting and reinforced disclosure of relevant risks by means of questions asked of clients, warnings given and the encouragement firms give clients to access information they make available.

Subsequent developments

4. During 2008 and 2009, compliance with the appropriateness requirements has been integrated into our ongoing supervisory activity for those firms affected. During 2009, we also reviewed a further sample of firms whose business models are particularly affected (including, notably, execution-only brokers and spread-betting firms). We found some further examples of good practice and robust implementation of the appropriateness requirements, although we also visited some firms where issues arose – these issues were formally raised with the firms in question.

22 FSA factsheet: *Implementation of the COBS 10 appropriateness test* (January 2009). See www.fsa.gov.uk/pubs/other/implementation_factsheet.pdf.

5. In our 2008 interim report, we mentioned questions that had arisen about our decision to apply the appropriateness test to non-financial spread-betting where firms offer this business through direct-offer financial promotions. As we said we would, we followed this up with the relevant firms to confirm and clarify our expectations with them and to ensure that these were understood.
6. In respect of spread-betting, FOS data for the year ended 31 March 2009 indicated that new complaints involving spread-betting received in that year nearly doubled (from 58 to 109), having been at a fairly constant level during preceding years. However, as with some other products, the FOS suggests that the effects of financial markets volatility on the performance of trades are likely to be the main driver for the magnitude of the increase in complaints about spread-betting.
7. That said, we have also seen some examples of individual complaints that have cited the new appropriateness test obligations, with which the complainant knows the firm in question is required to comply. In addition, our enforcement teams have taken the appropriateness test into account when looking at the behaviour of certain firms claiming to be transacting business on an execution-only basis. In such cases, there are some signs that the requirement has been helpful in obliging firms to be clear about the service they are offering and whether it is advised or not.

Other future developments that may have a bearing on COBS 10

8. The main development since our interim report in terms of the appropriateness requirement itself has been an exercise carried out by CESR during 2009 (including EU-wide consultation) to analyse how the requirement's distinction between complex and non-complex financial instruments should apply to types of instruments commonly traded by retail clients. The exercise resulted in a published CESR policy position (accessible on the CESR website), which we support.²³
9. The CESR work also raised some fundamental questions about the assumptions underlying the MiFID distinctions, particularly in light of the financial markets crisis since the directive was implemented (notably its treatment of structured investment products, asset-backed securities, and certain types of collective investment schemes). Some of the questions raised by CESR are also likely to be considered further in the course of EU negotiations on alternative investment funds, and in the proposals to extend MiFID standards (including appropriateness) to all PRIPs.²⁴ As noted in Chapter 4 (paragraph 17), the PRIPs work may also be complemented by a review of other aspects of the MiFID regime (for example, requirements for structured investment products and OTC²⁵ contracts). Both of these EU developments are likely to result in proposed changes to the MiFID requirements, which will in turn need to be reflected in COBS 10. The FSA will follow its usual procedures in consulting on such changes.

²³ CESR, Ref: CESR/09-559: *MiFID complex and non complex financial instruments for the purposes of the Directive's appropriateness requirements* (3 November 2009).

²⁴ When we implemented the appropriateness requirement, we decided not to extend it beyond MiFID firms and instruments except in respect of direct-offer business involving derivatives and warrants.

²⁵ Over the counter.

Other follow-up

10. Regardless of future external influences, our post-implementation review and comments from stakeholders has already led us to identify some potential changes to COBS 10. For example, it was suggested that we might remind firms in COBS 10.3.3G of their general obligations regarding risk disclosure to clients, notably under COBS 2.2.1R.²⁶ We agree, and will propose an additional piece of guidance for COBS 10.3, on which we will consult in a future QCP. This particular point was also underlined by CESR in its work on complex and non-complex products.
11. The point was made to us that the approach in COBS 10.2.7G (concerning providing information to a client to increase their knowledge) could present particular challenges for some consumers where the instrument or product in question is more complex. Spread bets were mentioned as an example of such a product where information explaining the risks and logistics of a transaction can be very technical.²⁷
12. We accept this point, but feel that the statements in COBS 10.2.7G recognise the issue and indicate the firm's obligations in taking this approach. Despite the challenges, an alternative line could imply that a firm cannot rely on educating an inexperienced client. This could mean that inexperienced clients can never transact in a product in which they have no experience, which could be an undesirable outcome.

26 COBS 2.2.1R:

(1) A firm must provide appropriate information in a comprehensible form to a client about:

(a) the firm and its services; (b) designated investments and proposed investment strategies; including appropriate guidance on and warnings of the risks associated with investments in those designated investments or in respect of particular investment strategies; (c) execution venues; and (d) costs and associated charges; so that the client is reasonably able to understand the nature and risks of the service and of the specific type of designated investment that is being offered and, consequently, to take investment decisions on an informed basis.

(2) That information may be provided in a standardised format.

27 COBS 10.2.7G: 'If, before assessing appropriateness, a firm seeks to increase the client's level of understanding of a service or product by providing information to him, relevant considerations are likely to include the nature and complexity of the information and the client's existing level of understanding.'

6 Product information disclosure

Background

1. The overall desired outcome for the COBS 13 and 14 product disclosure rules is for firms to provide readable and understandable disclosure documents (KFDs and illustrations) to their retail clients. This was also our expectation before November 2007. The 2008 review of a sample of KFDs showed that improvements were being made and that, therefore, the standards we expect are achievable and reasonable. The majority of firms surveyed in 2009 said that the COBS 13 and 14 rules were the ‘same’ to understand, with the rest saying that they were either ‘much’ or ‘somewhat’ easier.

Good and poor practice in KFDs

2. In addition to our general 2009 review work on product disclosure²⁸, we followed up on our 2007 review of good and bad practice in KFDs.²⁹ In early 2009, we reassessed over 70 updated versions of documents from the original 2007 sample. Our assessment comprised all of the updates of the least effective documents from the 2007 sample, and a selection of the updates of others where, in 2007, there was room for improvement. We found at least some improvement in all documents, and significant improvements in over two thirds. Most firms had improved the structure of their documents, but plain, succinct and jargon-free language remains elusive for some. The majority of documents where there had not been sufficient improvements were produced by the asset management sector. We published an update on this KFD review in April 2009³⁰, which provides useful guidelines about our expectations in this regard.

28 Including: the 2009 COBS PIR survey of large firms, a desk-based review of product risk warnings, and a review of waivers and modifications.

29 In 2007, we reviewed just over 200 KFDs spread across investment, life and pensions products.

30 FSA *Supplementary annex to good and poor practices in Key Features Documents* (originally published 28 September 2007) (April 2009).

3. In response to our 2009 survey of large firms, it is encouraging to note that all firms stated they had reviewed and amended their KFDs since November 2007. Most of these firms said this was with the consumer in mind, and two firms indicated that they had also undertaken customer research. Firms indicated that they had amended documents *'with the aim of creating a clearer, more user friendly document'*, to *'[reduce] lengthy explanations ... to ensure that customers were provided with key information rather than being overloaded with unnecessary and potentially confusing information'* and *'to further improve plain English aspects and brevity of documents'*. This feedback clearly demonstrates firms' desire to achieve our intended consumer outcomes (for example, consumers benefit from better-focused and higher-quality information).
4. We have noted the Association of British Insurers (ABI) recommendation in the July 2009 Customer Impact Panel Annual Report 2008/09³¹ that all members of the Customer Impact Scheme should consider their KFDs against the relevant section of the Scheme's 'Clear Language and Layout' good practice guide. We will monitor with interest the results relating to the clarity of material at the point of sale.
5. Overall, therefore, it appears that firms are increasingly focusing on producing KFDs that are 'fair, clear and not misleading'. Our own consumer testing conducted in 2008 suggests that many consumers find this material at least 'fairly clear', but just under 20% still have at least some difficulty understanding the documentation.³²

Risk warnings for non-MiFID and MiFID projections

6. Even though we implemented MiFID's higher-level approach for explaining risks to clients, the underlying standard (and required consumer outcomes) reflecting PRIN 7, changed little: a firm should take reasonable steps to ensure its customers understand the nature of the risks inherent in certain transactions.
7. COBS no longer requires prescribed risk warnings to accompany projections. The current rules require an 'appropriate risk warning' for non-MiFID products (COBS 13 Annex 2R 5.1) and 'a prominent warning' for MiFID products (COBS 4.6.7R). This enables firms to adopt new patterns of behaviour - for example, by altering and adapting risk warnings to reflect the nature, features and risks of their products better. Risk warnings previously prescribed in COB may still be valid, but we expect firms to assess whether the risk warnings they now use continue to be appropriate. Where they are no longer appropriate, we expect firms to make suitable adjustments.
8. Our 2009 desk-based review of 16 firms' risk warnings in disclosure material indicated these firms are mostly continuing to use the previously prescribed risk language. However, half of the large firms surveyed in 2009 as part of this PIR stated that they had tailored their risk warnings. We have not found that lower quality risk warnings have resulted from giving greater discretion to firms in this area.

31 See www.customerimpact.org for further information.

32 FSA Research no: 76 *Consumer Purchasing Outcomes Survey* (January 2009). This research was undertaken in July 2008, approximately 6 months after the COBS changes took effect. See www.fsa.gov.uk/pubs/consumer-research/crpr76.pdf.

Projections for MiFID and non-MiFID products

9. Projections are not mandatory for MiFID products, but if they are produced, they must be ‘based on reasonable assumptions supported by objective data’. Of those firms we surveyed in 2009 that produce projections for MiFID products, some indicated that they ‘still issue projections based on the previous COB rules’. There appears to be little evidence of firms changing their approach to projections in light of the rule change.
10. In response to our 2009 survey, some firms indicated that they were concerned that consumers would find it difficult to compare MiFID and non-MiFID products if standardised projections were not applied to both product types.
11. We have retained the requirement for MiFID firms to continue to provide Reduction in Yield (RIY) and Effect of Charges (EoC) information based on our standardised rates (or lower, where appropriate). Therefore, comparable information about the impact of charges for both MiFID and non-MiFID products is still available to consumers.
12. In October 2009, we took the opportunity to remind firms of their obligations when preparing projections for non-MiFID products. Our ‘Dear Compliance Officer’³³ letter reminded firms that COBS requires the standard projection rates (for non-MiFID products) to be revised down where they are likely to overstate potential investment returns (the most extreme example is the need to reduce rates for cash funds) and that the same rates should be used to explain the charges. However, it should be noted that this rule pre-dates COBS implementation, so compliance with the rule is not an indicator in itself of the effectiveness of the implementation of COBS.

Life policies: removal of the requirement to provide post-sale KFDs

13. As we set out in CP06/19³⁴, we did not expect the removal of the requirement to provide a post-sale KFD to result in reduced consumer protection because consumers already receive this information at the point-of-sale.
14. Our 2008 interim findings showed that many firms had decided to continue to provide post-sale KFDs and confirmations because it was not cost effective to change their post-sale systems at that time. Responses to our 2009 large firm survey suggest that some firms have decided to remove post-sales KFDs for some products (particularly new products), while continuing to prepare them for other products where they saw a need to do so.

33 See www.fsa.gov.uk/pubs/other/co_letter_projections.pdf.

34 FSA CP06/19 *Reforming Conduct of Business Regulation* (October 2006).

Rule waivers or modifications

15. We granted no waivers and seven modifications in respect of the product disclosure rules in the two years after the introduction of COBS, compared to 11 waivers and 55 modifications for the corresponding sections of COB in the two years before the rules changes.
16. This reduction suggests that the removal of some of the more detailed aspects of COB and the introduction of a more outcomes-focused approach has reduced the need for such firm-specific amendments.

Follow-up

17. Even though the indications from the large firms that responded to the 2009 survey are encouraging, we expect to see further improvements in disclosure documentation over time.
18. In order to assess ongoing progress and to follow up on both our KFD review work and our October 2009 Dear Compliance Officer letter on projections, we will undertake a further review of disclosure documents to review risk warnings and to ensure that firms are complying with the projections rules. We will take appropriate action where we find non-compliance.
19. We will also provide further supporting material and/or examples on our COBS webpages, if appropriate.

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: <http://www.fsa.gov.uk>

Registered as a Limited Company in England and Wales No. 1920623. Registered Office as above.