

# Compatibility with our general duties under the Financial Services and Markets Act 2000

1. This section explains our reasons for believing that making the proposed ‘menu’ rules is compatible with our general duties under section 2 of the FSMA 2000 and with the regulatory objectives set out in sections 3 to 6. We are required by sections 155(2)(c) and 157(3) of the FSMA 2000 to make this statement.
2. In CP166 we set out our proposals for liberalising the polarisation regime, as well as what this would mean for firms and consumers. To address the potential risk of a liberalised market working against the best interests of all parties concerned, we have introduced enhanced disclosure measures (the initial disclosure document in CP166, and now the menu in this CP). We view both disclosure documents as essential supports of depolarisation. Our aims in introducing them into the sales process is to create both a level playing field in the market and to counterbalance competitive forces that may operate against the consumer interest; and to provide clear, transparent and accessible information to consumers.

## **Our statutory objectives**

3. The menu proposals set out in this CP are designed, amongst other things, to help us meet two of our statutory objectives: securing appropriate consumer protection and promoting public awareness. We do not believe that they have any material impact on either our financial crime or market confidence objectives, but we do suggest that they contribute to achieving our objective to maintain confidence in the UK financial system.

## **Consumer protection**

4. It is reasonable to assume that a poorly informed market (one in which asymmetrical information exists between consumer and industry) is unlikely to operate effectively or efficiently, which in turn may lead to financial loss. In a market where consumers are unable to compare prices or identify what is

reasonable or value-for-money, there is little incentive for firms to compete on price or quality.

5. The requirement for firms to disclose the cost of advice is necessary to ensure an adequate level of consumer understanding and to support consumer protection in a deregulatory environment. Firms will be required to explain in the menu the services they provide and to present payment option information and illustrative commission amounts for both the firm and the market (shown by the ‘market average’) in a standard format. By requiring the cost of advice to be more transparent, we expect the risks to consumers associated with lack of information (and not shopping around) to diminish.
6. The consumer research revealed that respondents believed the menu made the financial services buying process more open and transparent, with most understanding that there were different ways of paying for advice, and that costs varied according to firm and product. In the consumer testing, one consumer commented: “... it’s more open and honest. You could not go to a bank now and get this”. The research also showed that the menu may encourage some price negotiation and shopping around (by the more sophisticated respondents). One consumer stated: “If ABC’s rates were above the market average, my instinct would be to question them as to why, and try to negotiate them down”.
7. We aim to mitigate the risk of consumers paying too much for financial advice as we expect the comparative nature of the menu information to exert a downward pressure on commission. Consumers need only visit one adviser to receive information on both the adviser’s charges and the average charges in the market. In providing a point of discussion, the menu (together with the market rate) will operate as an empowering negotiation tool which may lead to decreased commission levels. This will incentivise firms to compete on price and quality, make the market work more effectively and, ultimately, reduce the need for regulatory intervention, and help consumers get a fair deal.
8. In considering the appropriate degree of consumer protection, we have had regard to the following issues.
  - (a) *The differing degrees of risk involved in different kinds of investment or other transaction*
9. If the menu proposals are introduced, there is the risk of consumer confusion due to information overload and the perceived complexity of the subject matter. However, prescriptive disclosure in the menu document of payment options available and the illustrative cost of advice – in plain language – is designed to avoid consumers being exposed to any new risk in this regard. We have prescribed a standard, and understandable, format for disclosing advice

costs across different product groups to make consumers aware of the varying cost of advice for different product groups.

10. Our consumer testing confirmed that the menu helps consumers to understand the issues surrounding the cost of advice much more clearly than at present. So, we do not expect significant consumer confusion – and therefore sub-optimal decision making – to develop. Relative to the current regime, the proposals should lead to better informed and, therefore, empowered consumers.

*(b) The differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activities*

11. Our menu proposals are focused on customers who fall within our definition of private customer. We do not intend to apply our proposals to business carried on with other types of customers.
12. The proposals are designed to give consumers a clear, concise and easy-to-use document. Our consumer research examined consumer understanding of the different payment options and the illustrative cost of advice (alongside the market average) across a range of consumer sophistication. The research showed that the new document was effective in increasing understanding.

*(c) The needs that consumers may have for advice and accurate information*

13. The menu does not undermine the importance of financial advice. It has been designed to increase consumer awareness and understanding of the cost of advice earlier on in the advice and sales process in order to diminish any information disadvantage for consumers. The menu has prioritised relevant information, but also specifies that consumers should ask their advisers for any help and further information. The document tested well in a mock sales interview environment and we anticipate advisers using it as a tool to explain payment options and the relative cost of advice to consumers.

*(d) The general principle that consumers should take responsibility for their decisions*

14. The menu proposals are part of our overall regulatory strategy aimed at providing consumers with clear, understandable and easy-to-use information in good time before making a decision. This will allow consumers to make comparisons (or shop around) and, ultimately, make any decision to buy (or not buy) a financial product on a sound and reasonable basis.
15. By requiring disclosure of the cost of the firm's services in comparison to the market average, we aim to provide consumers with additional information to

help them to make independent and informed decisions about whether or not to use a particular firm's services. This information should further contribute to their financial awareness and protection, empowering consumers to shop around, as well as provide a sound basis from which to negotiate the price of the service on offer.

### **Public awareness**

16. By improving the supply of consumer information about the cost of financial advice, the menu proposals help promote public understanding of the financial system. In particular, the proposals promote awareness of the different options available for paying for advice, and of how the cost of advice varies and compares between firms across the retail market. We expect our proposals to make consumers understand that advice has a cost and that there are choices to be made when paying for that advice. Reliable, understandable and accessible information is essential if consumers are to make the right choices.
17. Our consumer research demonstrated that most consumer participants understood that there were different ways of paying for advice, and that costs vary between firms and products.
18. Transparency and increased awareness will necessarily act as a counter-balancing force to limit the extent commission levels may be negotiated upwards. This is because the menu disclosure should operate to even out the balance of negotiating power between providers, distributors and consumers.
19. Enhanced disclosure should increase consumer awareness and understanding of the cost of advice and pose no significant risk to the advice market. In the testing, consumers stated: "[The menus] are useful because they set out the different payment options and give examples".
20. Consumer testing demonstrated that the menu prompts consumers to ask advisers appropriate questions. The market average was found to be a useful part of the menu – optimising its overall helpfulness to consumers. Consumers stated: "The market average could encourage me to ask them to explain why they are more expensive and to assure me that I'm not being ripped off".
21. The benefits of the menu are not restricted to pre- or point-of-sale situations. Consumer proxies, such as personal finance journalists and consumer bodies, can influence the market because of their ability to interpret public domain information to the advantage of consumers in general.
22. In promoting public understanding of the financial system, we have considered the following matters.

*(a) Promoting awareness of the benefits and risks associated with different kinds of investment or other financial dealing*

23. Our disclosure improvements have been designed to raise consumer awareness of the benefits and risks associated with the provision and receipt of financial advice. The menu specifically encourages consumers to shop around and decide which firm to use, and to ask the adviser if any more help or information is required.
24. This information is provided to the customer at the outset of the sales process and will enable consumers to decide whether they want to make use of a firm's services if they believe the costs are reasonable, or to engage in a discussion on cost.

*(b) The provision of appropriate information and advice*

25. We propose requiring the use of the 'key facts' logo to make the menu consistent with other essential disclosure documents elsewhere in the retail market. This should build consumer awareness generally of 'key facts' branding and information, which should help them better identify and understand how the menu can help them to make the right decision about which firm to use.
26. We have designed the menu so that it contains enough relevant information for consumers to make more informed choices, though it also specifically directs consumers to ask for more help if required. We have also included a prominent regulatory statement on the document itself which directs the consumer to their role in the sales process.
27. We will support the effective functioning of the new menu document through consumer information and education measures. This will address the public awareness objective in more detail.

**Market confidence**

28. The menu proposals will affect the retail market informally in that they are aimed at promoting a more efficient market in which consumers can have confidence.
29. By improving the transparency of information on the cost of advice to consumers, we expect to encourage shopping around for financial advice. Our consumer testing concluded that respondents viewed the documentation "very positively" and found the information contained in the new menu document "useful" and "user friendly" in deciding whether to use a particular firm or adviser. Requiring all firms to provide this information made respondents "feel more confident that everything would be 'above board'". This suggests that general market confidence is likely to increase on implementation of these rules.

30. An asymmetrical balance of information can prevent a market from functioning effectively. Balancing information between industry and consumer should increase consumer confidence. This should contribute to the overall health of the financial services industry, with confident consumers promoting innovation and stimulating better value, resulting in the production of better products at lower prices.

### **Financial crime**

31. There is no material impact on meeting the objective of reducing financial crime.

### **Matters to which we must have regard when we carry out our general functions**

32. Under the requirement set out in section 2(3) of the Act, in carrying out our general functions, we have had regard to the specific matters set out below.

*(a) The need to use our resources in the most efficient and economic way*

33. There may be a temporary increase in our monitoring of the packaged product market following the rule change (to ensure that the new rules work and are being followed). However, we do not expect the menu proposals to materially affect either our systems and processes for the supervision of firms, or the costs that we incur.
34. The menu proposals will contribute to an increase in consumer awareness which may reduce the extent to which we may be required to intervene to address information imbalances.

*(b) The responsibilities of those who manage the affairs of authorised persons*

35. The menu proposals have no bearing on the responsibilities of managers beyond those currently required by our Principles for Business, and Senior Management arrangements, which include: taking appropriate practical responsibility for their firms' arrangements in relation to confidence in the financial system; the fair treatment of firms' customers; and the protection of consumers.

*(c) The principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from that burden or restriction*

36. The CBA sets out estimates of direct and compliance costs as well as an analysis of the benefits and indirect costs. The 'most appropriate' statement at (h) below sets out the reasons why we believe the menu is the most appropriate policy.

*(d) The desirability of facilitating innovation connected with regulated activities*

37. Increased awareness of the cost of advice might cause consumers to consider the quality of the advice service more carefully. This could encourage firms to adopt innovative approaches to the advice service and introduce quality improvements as they seek to differentiate themselves from their competitors.
38. If maximum commissions become a focal point, firms may be less willing to sell new products where the new product is expensive to sell (for example, the firm needs to familiarise itself with the product) unless the firm can communicate to consumers that the higher costs of the sale are justified.

*(e) The international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom*

39. We do not believe there are any significant implications for this principle.

*(f) The need to minimise the adverse effect on competition that may arise from anything done in the discharge of those functions*

40. In designing the proposals we have sought to minimise the possibility that they could contribute to a situation in which there is collusion (tacit or otherwise) whilst maintaining the relevance of disclosures to consumers.

*(g) The desirability of facilitating competition between those subject to any form of regulation by us*

41. In designing these proposals we have sought to facilitate competition in the provision of advice on packaged investment products.
42. The menu may facilitate competition by increasing awareness of the cost of advice. This might cause consumers to consider the quality of the advice service more carefully and be more demanding of the service that is provided which could act as a spur to competition.
43. The menu could indicate to consumers that the cost of advice may vary between firms and advisers. This could encourage more consumers to shop around. To the extent that this shopping around is effective, this could also act as a spur to competition.

*(h) Acting in a way most appropriate for the purpose of meeting our statutory objectives*

44. We have previously consulted on different formats of adviser commission and remuneration disclosure, but we have found that the menu format is

preferable and believe it to be the most appropriate means of meeting our various policy objectives for disclosure. Those objectives are:

- to make clear that there is a ‘cost’ to advice which ultimately has to be met through the charges which a firm takes on the products it sells;
- that a firm may have an incentive to sell one investment product in preference to another because of different commissions, even though the products may be equally suitable (product bias);
- that a firm may have an incentive to sell one provider’s product in preference to another provider’s product of the same type, again because different commissions are on offer (provider bias);
- that a firm may sell a product for a longer term, or for a higher premium, than is necessary because that will generate higher commission (overselling);
- that making commissions being paid to firms more transparent will exercise some downward pressure on commissions which should ultimately lead to lower charges for consumers (an astute individual consumer is already able to negotiate commission downward and, through ‘enhanced allocation’ or otherwise, to reduce net charges on the product);
- that, empowered with information about commission at an early stage, consumers may be put in the position where they are able to shop around among firms or negotiate with an individual firm over the possibility of a rebate;
- to require provision of the menu in all distribution channels because, following depolarisation, we expect these channels to compete.

45. Our consumer research showed that the proposed measures to improve consumer awareness and understanding of the cost of advice were effective. Consumer reaction to the proposed menu was sufficiently positive to give us confidence that there will be an actual change in consumer behaviour, with more consumers shopping around. For example, one consumer commented: “I would probably keep the comparisons of costs and, before making a decision, get another company’s point of view and compare”.
46. Together with our proposals for depolarisation (put forward in CP166), which necessitate enhanced disclosure generally, we believe that our proposals for commission disclosure at an early stage in the advice and sales process will also contribute to our consumer protection and public awareness statutory objectives.
47. We do not believe that there is any other available and appropriate regulatory tool more likely to deliver these statutory, and our policy, objectives (as well as significant improvements to consumer understanding and confidence) than the proposed prescriptive enhanced disclosure rules, accompanied by a programme of consumer awareness measures.

# Cost benefit and market failure analyses

## Cost benefit analysis

1. The Financial Services and Markets Act 2000 (FSMA) requires us to undertake and publish a cost benefit analysis (CBA) to accompany our proposed rules and guidance<sup>1</sup>. This annex sets out our estimate of the costs and our analysis of the benefits that may arise if the proposed rules for the introduction and maintenance of the menu format of remuneration disclosure are made following depolarisation.
2. A cost benefit analysis is not required if we consider that there will be no increase in costs or, if there will be an increase in costs, we consider that the increase will be of no more than minimal significance<sup>2</sup>.

## Proposed rules

3. The proposed rules on disclosing information about fees and commission (where packaged products are sold) support Principle 7 (Communication with clients) where we have identified a need for private customers to have information at an early stage about the basis on which a firm may be remunerated. The proposed rules also give effect to the UK's obligations arising from the IMD.
4. A firm must take reasonable steps to ensure that its representatives – on first making contact with a private customer with a view to advising on packaged products – provide the customer (on paper or any other durable medium) with information concerning the firm's arrangements for charging and receiving fees and commission (a “fees and commission” statement). There is no obligation to agree on fees and commission charges up-front. However, the firm must reasonably consider that the information it provides is likely to be appropriate for the customer, having regard to the type of service that it may provide or business it may conduct.

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1 Sections 155 and 157 FSMA

2 Section 155 (8) FSMA

## Policy objectives

5. In proposing the above rules, our policy objectives have been to:
  - reduce commission bias (both product and provider bias);
  - exert downward pressure on commission levels as a result of achieving greater awareness of the cost of advice;
  - encourage shopping around (and negotiation); and
  - thereby promote consumer empowerment.
6. In CP166 we said that we do not propose removing the polarisation restrictions until we have concluded consultation on the menu rules. CP166 set out our proposed rules for depolarisation (including proposed rules for the initial disclosure document – IDD). It also contained the related cost benefit analysis (which was based on a cost benefit report prepared by National Economic Research Associates)<sup>3</sup>.
7. As well as its analysis on depolarisation, the NERA report covered alternative proposals for adviser remuneration, including the menu option. The NERA report refers to the menu option as the ‘price list’.
8. The scope of this CBA relates only to the proposals set out in this CP for the introduction and maintenance of the menu format of remuneration disclosure. However, our conclusions here are closely aligned with our proposals for depolarisation generally, and are based on the main findings and assumptions of NERA. So, this CBA should be read together with the CBA published with CP166.

## Costs

### *Direct costs to the FSA*

9. We have already incurred the following direct costs:
  - developing the proposed menu rules;
  - designing the menu template;
  - formulating the calculation methodology for the market average;
  - consumer testing the menu; and
  - devising a consumer education programme.
10. We have estimated these costs to be approximately £490 000.<sup>4</sup>

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<sup>3</sup> “Cost-benefit analysis: Depolarisation and the remuneration of financial advisers - A Report for the Financial Services Authority”, 20 December 2002, prepared by National Economic Research Associates (NERA)

<sup>4</sup> Policy and rules development £354 900 (£364 x 975 days); market average calculation advice £50 000; consumer testing £85 000 [£489 900]

## *Ongoing costs to the FSA*

### *Monitoring and supervision*

11. In carrying out our general functions, we are required to use our resources efficiently and economically. Therefore, we follow a risk-based approach to our supervision of authorised firms. There may be a temporary increase in our monitoring of the packaged product market following the rule change (to ensure that the new rules work and are being followed). However, we do not expect the menu proposals to materially affect our systems and processes for the supervision of firms, or the costs that we incur.
12. The menu proposals will contribute to an increase in consumer awareness which may reduce the extent to which we are required to intervene to address information imbalances.

### *Market average calculation*

13. We will incur the following additional ongoing costs in calculating the market average:
  - specifying, collecting and analysing commission, commission-equivalent, and rebating data (from a sample of firms – this will result in a compliance cost for 150 firms surveyed, totaling approximately £20 000 each year);
  - producing relevant indicative figures for the market average to be disclosed in the menu;
  - procuring internal agreement; and
  - answering queries.
14. We will calculate the market average yearly. We estimate an annual cost to the FSA of £44 000<sup>5</sup>.

### *Compliance costs for firms*

15. We have estimated that the additional one-off compliance cost to firms of implementing and complying with the new menu rules requirements is £39.75 million; and the ongoing compliance cost to firms is £22 million per year. The key components of these compliance costs are summarised in Table 1 below (and are largely based on NERA's assumptions).
16. Although these cost estimates are based on NERA's assumptions, they differ from NERA's estimates published with CP166. NERA assessed the relative costs of the three options for disclosure of adviser remuneration, and its

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<sup>5</sup> 120 days x £364 (£43 680).

estimates were based on a form of the menu which we have developed over the course of 2003. We have revised the CBA as details of the menu have developed, and as we have gained a better understanding both of what would be necessary to construct the ‘market average’ figures contained in the menu, and how the menu would be used by consumers and advisers. We now have clearly specified rules for the menu and its use. So, we have been able to more accurately assess the costs attaching to the menu.

17. Specifically, we have reduced:

- the time necessary for training;
- the time for rewriting compliance manuals;
- the costs incurred by large firms to make systems changes;
- the number of provider firms; and
- the time that management will spend on implementation.

**Table 1: Compliance costs of menu (£ millions)**

<b>Item</b>	<b>One-off cost</b>	<b>Ongoing cost (per year)</b>
<b><i>All firms</i></b>		
Management time	£9.5	
<b><i>Providers</i></b>		
System costs	£3.75	
Administration costs of market rate		£0.25
<b><i>Tied advisers</i></b>		
Rewrite compliance manuals	£0.25	
Printing costs		£0.5
Training costs	£4.5	
System costs of preparing and updating menu	£10.25	
Explain menu to clients		£14
<b><i>IFAs</i></b>		
Rewrite compliance manuals	£2.25	
Printing costs		£0.25
Training costs	£5	
System costs of preparing and updating menu	£4.25	£0.5
Explain menu to clients		£6.5
<b>Totals</b>	<b>£39.75</b>	<b>£22</b>

18. The cost of explaining the menu to clients includes the cost of consumer time. This accounts for approximately half the amount stated above for tied advisers, and approximately one-third of the amount stated above for independent advisers.

19. We do not expect that in practice the total sales time will necessarily increase by the time spent directly on the menu. This is because the costs of advice are already discussed to some extent. Some of that discussion will now take place in the context of the menu.
20. NERA's discussions with firms suggested that there would be an ongoing systems cost for small IFAs due to their likely approach to preparing and updating the menu compared with other firms.

#### *Indirect costs*

21. Commissions may become a 'false focal point' by distracting consumers away from other information causing them to make poor decisions. For example, commissions are one element of total product charges, and it is total product charges that affect returns on investments.
22. The menu may lead firms or advisers to change their behaviour in ways that have perverse consequences.
  - Firms or advisers may (subject to the requirement for independent advisers to offer advice from the whole market) stop dealing with products that are expensive to sell. This could lead to reduced availability of suitable or good value products.
  - Innovative products (or new providers) may need to offer higher commissions to incentivise firms and advisers to familiarise themselves with the product (or provider), which may make market entry or launching new products more difficult. This potentially reduces competition.
  - Product providers may be encouraged to produce products with lower commissions, but this would not necessarily mean that total charges would be lower. There may also be a reduction in variety. For example, there could be reduced availability of products with useful add-on features that take longer for firms or advisers to explain, and this may necessitate a higher commission to secure distribution.
23. There are aspects of the menu that could conceivably reduce effective shopping around.
  - We have assumed that the menu will add to the time the sales process takes. For those consumers that go through multiple sales processes, this may mean that they are less willing to do so.
  - The inclusion of the market average may discourage shopping around if the firm's maximum commission is close to the market average (or the firm satisfies the consumer that the commission will be close to the market average).

- Consumers may only shop around on the basis of maximum commissions, although there may be other bases on which to shop around.
24. It is possible that firms might successfully persuade consumers that the market average is the ‘going rate’ and this could lead to firms setting their maximum commissions close to the market average (which may bring the market average down). The incentive to give consumers a better deal would only be there if it attracted consumers away from competitors.

## **Benefits**

25. In analysing the economic benefits, it has been challenging to anticipate consumer and industry behaviour on introducing the menu into the advice process. However, the following analysis is based on our expectations of the benefits that may be generated on introducing the menu.<sup>6</sup>
26. The menu might make consumers more aware of commissions and how they vary between products and providers, and across the market. This could alert consumers to the possibility of commission bias. Informed consumers might be better able to recognise, and less likely to act on, biased advice<sup>7</sup>. To the extent this happens, fewer unsuitable and bad value products may be sold.
27. By presenting consumers with market average commission amounts and advisers’ maximum commission amounts, the menu might increase consumer awareness of the cost of advice. This could encourage greater negotiation over fees and commissions. Where commissions and fees are not cost-orientated this may lead to commissions and fees reflecting more closely the underlying costs of providing advice, improving the allocation of resources. To the extent that reductions in fees and commissions occur (and, in the case of commissions, this is passed on to consumers) there will be an increase in consumer surplus (and a corresponding reduction in industry surplus).
28. A greater understanding of the level and effect of commission (and, in particular, the level of commissions received across the market) should increase consumer awareness of the scope for negotiation. This may lead to increased rebating.
29. Increased awareness of the cost of advice might also cause consumers to consider the quality of the advice service more carefully. This could encourage quality improvements. Additionally, this could also contribute to an increase in variety as firms or advisers seek to differentiate themselves with alternative cost-quality offerings.

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6 Subject to many factors, including: the continuing misalignment of incentives caused by current remuneration structures; and adviser use of one-to-one interactions with consumers.

7 We have some empirical evidence of the existence of bias in the current independent sector (which could become a wider concern in a depolarised market). See Charles River Associates Ltd report “Polarisation: research into the effect of commission based remuneration on advice”, January 2002

30. The menu could indicate to consumers that the cost of advice may vary between firms and advisers. This could encourage more consumers to shop around. If this shopping around is effective, consumers could benefit from better cost-quality combinations.
31. Despite their incentives, firms or advisers might be less inclined to sell high commission products (in cases where the high commission cannot be justified, for example, in terms of product or advice quality) as this may make them appear less competitive. To the extent this happens, and to the extent that commissions and total charges are correlated, this could reduce the likelihood that bad value products will be sold.
32. To the extent that the menu becomes a focus for the FSA, the financial media, and consumer bodies (as they have the ability to interpret public domain information), firms or advisers may feel obliged to justify commissions above the market average. This could lead to a reduction in commissions where they cannot be justified with reference to factors such as product complexity, efficiencies elsewhere, product quality or the quality of advice. To the extent that commissions and total charges are correlated, this could reduce the likelihood that bad value products will be sold.

### **Amending the commission equivalence rules (for tied advisers)**

33. We propose amending our rules associated with commission equivalence for tied advisers (COB 5.7). The main change will be to introduce guidance on the method of calculating the commission equivalent figure – based predominantly on a guidance note issued by the Institute and Faculty of Actuaries (GN 22).
34. Redrafting the existing rules and guidance in this area has been an important part of developing the menu in that it has been necessary to capture the same ‘cost of advice’ elements in remuneration that exist for commission. The figures should now represent a much more appropriate and fair comparison against actual commission or a fee, as they have resolved anomalies in the calculation. We believe this will help consumers to compare the menus of different advisers.
35. Firms should not need to significantly adapt their systems or management accounting practices to make the calculation following the new guidance. The calculation of commission equivalent applies only to a limited number of product providers and to firms connected to product providers. These firms, because of the new rules, will have to review their existing practices and take account of any changes they identify.
36. On this basis, we have concluded that any incremental costs associated with recalculating commission equivalent figures are adequately covered in the system cost estimates set out in Table 1. We do not believe that there will be

an increase in ongoing costs as the proposed rules change what firms already have to do, rather than require them to perform something new.

### **Changes to the depolarisation rules since CP166**

37. This CP also consults on some policy changes to the draft depolarisation rules originally consulted on in CP166. One of those changes is the extension of the scope of the ‘investment by product provider’ rules to include all intermediary firms. The CBA in CP166 expected that benefits would be generated as some tied advisers opted to become multi-tied. However, as a result of this policy change, these expected benefits may be lower in that, at the margin, fewer tied agents may opt to become multi-tied.
38. In practice we would expect this impact to be very small as the type of investment by product providers this rule is designed to stop is unlikely to be a high priority in business plans. There are, of course, likely to be benefits as this rule should mean that multi-tied firms will be less likely to favour one product provider over another.
39. We believe that the draft depolarisation rules published with this CP do not differ from the draft rules published with CP166 in a way that will have a materially different impact on any group of significant stakeholders. In this regard, we have not revisited the CBA published in CP166.

### **Conclusion**

40. We will take appropriate steps (particularly through providing transitional relief, prescribed menu templates, and analysis of commission information to be provided by firms) to mitigate some of the compliance costs likely to be faced because of these rules changes.
41. The consumer research concluded that the menu was successful in reaching its key objectives: that consumers understand that advice has a cost, and that that cost varies between firm and product. The research also showed that the menu may also encourage some price negotiation and shopping around (by the more sophisticated respondents).
42. As a result of previous consultation we have also found that the menu format of adviser remuneration is preferable to other forms of remuneration disclosure we have considered.
43. In its report NERA concluded that if the proposed menu format of remuneration disclosure is successful in promoting price awareness among consumers, increasing the possibility of greater shopping around, and reducing commission bias (through improving the quality of advice), then it believed it could deliver significant net benefits.

Q15: Do you agree with the cost estimates of our proposals? If not, do you have further information that we should take into account in these estimates?

Q16: Do you agree with the benefit analysis of our proposals? If not, what considerations should we take into account in this analysis?

### **Market failure analysis**

44. The market failures are information asymmetry and principal-agent problems. Many packaged investment products are both complex and opaque. As a result many consumers cannot compare these products on an objective basis prior to purchase. Consumers may not be able to learn from experience as they do not buy these products frequently and in any event it can be difficult for them to make a self-assessment of product suitability and value after the event. (And even if they could, in the case of many products – such as a pension – it could be too late.) This means consumers are very reliant on the advice that they are given to decide on which product is suitable and good value.
45. Advisers have a duty to act in the interests of the consumer. However, they or their employees are typically remunerated by commissions which are available from product providers. This can lead to a situation where an adviser has an incentive to sell a product because they get a high level of remuneration from the product provider for doing so and this conflicts with their duty to act in the interests of consumers, who cannot tell when advisers do not act in their interests.

#### *The significance of the market failure*

46. The confluence of these two market failures can mean that commission bias is likely. Advisers may sell products that are unsuitable and/or bad value to consumers who are not in a position to tell that they are being sold a sub-optimal product.
47. Charles River Associates (CRA) conducted research into commission bias and found commission bias for a small number of single premium products. Bias was most prevalent amongst IFAs. In 2001, CRA estimated consumer detriment as a result of this bias amounted to £140M per year. (Note that CRA only considered certain products so may have not detected some bias.) On the other hand, changes in product portfolios since they completed their research (in particular, the declining sales of with-profit bonds) may mean there is now less detriment in the areas that they did consider.

*Will the market or existing regulation counteract or correct this market failure?*

48. We consider it unlikely that, left to its own devices, the market will resolve this failure. Given widespread consumer distrust of financial advisers, there may be a market opportunity for an adviser that can demonstrate that it is not biased by commissions. However, it does not appear to have been taken up to date at the mass market level.
49. FSA regulatory intervention is based on the disclosure of total charges, product characteristics and commissions. These disclosures tend to be made at a late stage in the sales process when the consumer will probably be disinclined to query commission levels or to shop around. Comparators at the point of sale also tend to be lacking (the comparative information tables are not discussed as a matter of course at point of sale). This makes it difficult for the consumer to judge whether the advice they are receiving is potentially biased or bad value.

*How the menu will address market failure*

50. The menu seeks to address the information asymmetry directly and, through this, the principal-agent problem. Please refer to the 'Benefits' section of the cost benefit analysis starting at paragraph 25 above; in particular, see paragraphs 26, 27 and 31.

# List of non-confidential responses to CP166

Abbey National plc	Edinburgh Fund Managers plc
AEGON UK plc	Endsleigh Independent Financial Services Ltd
Alliance for Finance	Ethical Investment Research Service
AMP (UK) plc	Fidelity Investments Ltd
The Association of British Insurers	Financial Futures (IFA) Ltd
Association of Independent Financial Advisers	Financial Ombudsman Service
Association of Private Client Investment Managers and Stockbrokers	Financial Services Consumer Panel
Association of Solicitor Investment Managers	Financial Services Training College
Britannic Asset Management	First Direct
Britannic Money plc	Friends Provident Life and Pensions Ltd
British United Provident Association	Halifax Financial Services
Cazenove Fund Management Ltd	HSBC Group
The Children's Mutual	Insight Investment Management Ltd
Clarke Roxburgh Financial Planning Ltd	Institute of Actuaries
Clerical Medical Investment Group	The Institute of Chartered Accountants in England & Wales
Richard Cockroft	Intermediary Mortgage Lenders Association
The Consumers' Association	INVESCO Asset Management Ltd
Co-operative Insurance Society Ltd	Investment & Life Assurance Group

Investment by Design Ltd	Solicitors for Independent Financial Advice Ltd
The Law Society of Scotland	Southern Pacific Mortgage Ltd
The Law Society	Standard Life
The Law Society's Company Law Committee	Swiss Life (UK) plc
Legal & General Group plc	Teachers Provident Society Ltd
Life Insurance Association Ltd	Thornton Lambert Ltd
London Stock Exchange	threesixty services LLP
M&G Financial Services Ltd	UK Social Investment Forum
Merrill Lynch Europe plc	Virgin Money
MoneyScience Investment Consultancy	Wesleyan Assurance Society
Mortgage Next	Yorkshire Financial Clinics Ltd
National Australia Bank	Zurich Financial Services
The National Consumer Council	
Norwich Union	
Office of Fair Trading	
Pearson Jones plc	
Phil Billingham Associates Ltd	
Pinnacle Insurance plc	
Prudential plc	
Royal London Mutual Insurance Society Ltd	
Sainsbury's Bank plc	
Scottish Widows Group	
Simmons & Simmons	
Skandia Life Assurance Company Ltd	
Small Business Practitioner Panel	
The Society of Financial Advisers	
The Society of Pension Consultants	

# Feedback statement to CP166

1. We received 80 responses to CP166. Nearly two-thirds of these respondents also responded to CP121. The majority of responses came from product provider firms. The trade associations formed the second largest group of respondents. Overall, the majority of all respondents were in favour of our proposals, and every question drew a favourable majority response. The questions on relaxing the requirement for holdings in or credit to independent advisers to be at arm's length, and allowing appointed representatives (ARs) to have different ranges from their principals drew the most opposition, although those opposed remained in the minority.
2. In each section of this annex we set out the information provided in the following format:
  - a summary of the proposal set out in CP166;
  - the specific question asked in CP166;
  - a summary of the responses received to that question; and
  - our feedback to the responses.

## Responses generally

3. Before dealing specifically with each question, it is worth noting four general themes running through the responses, as well as our initial feedback to each.
  - Some respondents sought to re-open issues – such as whether depolarisation should go ahead at all – that have long since been settled.

**Our response:** We have considered the arguments put forward, but in our view they do not present a convincing rebuttal of the thorough analysis advanced during the review of polarisation for fundamental change (the London Economics report, CP80, CP121, CP166 and the various research reports published with each of those CPs).

- Some respondents requested more guidance on various issues where we do not think there is a need for FSA rules.

**Our response:** The depolarisation package is, as Howard Davies wrote to the Chancellor in November 2000, significantly deregulatory. The draft rules in CP166 were aimed at providing a high-level framework for firms within which senior management would be expected to take appropriate practical responsibility for their firms' arrangements, alongside appropriate and robust systems and controls, to meet the FSA's requirements.

- Respondents opposed to any change argued that unfettered deregulation would lead to an unwieldy market structure which, in turn, would not be understood by consumers.

**Our response:** We firmly believe that commercial considerations will continue to be a powerful factor in keeping distribution models relatively simple, rather than resulting in the complexity predicted by opponents of depolarisation. Therefore, and mindful of any competition concerns, we do not intend to re-introduce restrictions on how firms structure their business models.

- Some respondents were concerned about the volume of information that would be required to be given to consumers at the start of the advice process, especially when viewed against the further documentation required to be handed to consumers during the process and after the sale.

**Our response:** This argument misses the point. We believe that enhanced disclosure is the essential support for the depolarisation structure, and a small price to pay for the freedom that a deregulatory environment will allow. Also, if we did not require additional disclosure in a deregulatory environment we would be failing to meet at least two of our statutory objectives: public awareness, and the protection of consumers.

### **The proposals for 'scope' and 'range', and to allow firms to have more than one range of products**

4. The draft rules contained in CP166 introduced the concepts of 'scope of advice' and 'range of products'. A firm's scope is the basis on which a firm selects products: from the whole market (or the whole of a sector of the market); or from a limited number of providers; or from a single product provider. Firms would be able to offer advice with a different scope to different customers. For example, it would be possible for a single firm to have a whole-of-market scope for its 'high net worth' customers and a scope from a limited number of providers only for other customers.
5. Firms would be required to provide the specified scope of advice based on a particular range, or list, of packaged products.
6. Where a firm advises a customer on products from a single product provider, or from a limited number of product providers, its range of packaged products will be some or all of the products offered by the providers selected. On the other hand, where a firm offers advice from the whole market, its

scope will be all of the firms who manufacture products in the whole market (or the whole of a specified sector of the market), and its range will be all the products from the whole market (or the whole of a sector of the market).

7. We do not intend to prevent firms from making ‘out-of-range’ recommendations in certain circumstances. We are requiring firms to have a range (or ranges) to ensure that customers are clear about what choices they are being offered.
8. **We asked:** Do you agree that our proposal to allow firms to have more than one range of products is the most appropriate way of liberalising the arrangements for advice and the sale of packaged products?
9. Two-thirds of the respondents who commented on ‘scope’ and ‘range’ were in favour of liberalising the market in this way and felt it was a logical and pragmatic step. These respondents anticipated that a liberalised market would offer increased consumer choice.
10. Respondents also appreciated the greater flexibility that this would allow in that firms would be able to have diversified product ranges to meet different consumer needs. It was noted that this could be particularly cost-effective within a single sales force.
11. Respondents anticipated greater freedom in how they structure their businesses and, as a result, saw considerable scope for marketing initiatives within less prescriptive distribution channels. However, many respondents recognised that this flexibility may be constrained by costs and the practical difficulties of maintaining significant numbers of different product ranges. Respondents acknowledged that liberalising the restrictive arrangements which currently apply in the tied sector would make the market more cost-effective.
12. Although respondents were concerned about the potential for concurrent, diverse and complex ranges to develop (which might lead to consumer confusion), they felt that, in practice, the market would operate to restrict the development of numerous complex product ranges. These respondents felt that the majority of advisory firms would want to develop relatively clear and unambiguous advice models.
13. Nearly all respondents recognised the need to ensure effective full disclosure of what is being offered to the consumer, and agreed with our proposed additional safeguards to accompany depolarisation. There was support for our ‘tick box’ approach in the IDD to explain the concepts of scope and range to consumers.

**Our response:** These proposals were designed to meet the criticisms of the polarisation regime by the DGFT and to meet the pledge on behalf of our Board (given by Howard Davies, our former Chairman, to the Chancellor) that polarisation would be subject to fundamental reform. So, we intend to proceed with the scope and range proposals as set out in CP166.

Where respondents envisaged complex control issues arising (in administering various scopes and ranges, and monitoring out-of-range recommendations), we expect robust processes to be put in place to ensure compliant behaviour.

Senior management should ensure that the information needs of their firms' customers are met, and that that information is communicated to them in a way which is clear, fair and not misleading. This will alleviate consumer confusion over adviser status, and prevent consumers being misled.

Firms should continue to meet the 'know your customer' and suitability requirements appropriate to the type of advice being given, and product being recommended or sold. This will apply equally to any out-of-range recommendations made.

### **The proposal allowing the term 'adviser' to be used for any individual giving advice within the meaning of the Regulatory Activities Order (RAO)**

14. The draft rules in CP166 referred to 'firms' in general, as opposed to the 'product provider' and 'independent intermediary' distinction we currently make under polarisation.
15. In future, firms will differ according to their scope of advice and the range or ranges of packaged products they advise on. We have not devised descriptive terms for all the possible types of firms that may exist in a depolarised market. We expect firms to decide how to describe themselves, as long as any description is clear, fair and not misleading. However, we do stipulate that firms may only describe themselves as 'independent' if they offer advice from the whole of the market (or sector of the market) and the option to pay by fee.
16. Our preliminary view was that it would be inappropriate to introduce any restrictions on the use of the description 'adviser' for individuals. Both independent and tied advisers are required to be qualified to the same basic standard, to be trained and competent for the activities which they undertake, and both are also subject to identical standards regarding 'know your customer' and suitability. In regulatory terms, the only difference between individual advisers is that some, by virtue of the scope and range of the firm which employs them, are able to advise on products from a greater number of providers than others. Also, the activity of advising customers to buy specific investments constitutes 'advice' for the purposes of the RAO.

17. Since we proposed removing the distinction between firms, it no longer made sense to continue to use the different descriptions of ‘adviser’ and ‘representative’. So, we decided that all firms and their employees will be able to describe themselves as ‘advisers’ or as ‘representatives’ or any other descriptive term that they think defines their role, as long as it is clear, fair and not misleading to customers.
18. **We asked:** Do you agree that the term ‘adviser’ should be allowable for any individual giving advice within the meaning of the RAO?
19. Two-thirds of respondents who answered this question were in favour of the proposal. Most respondents also supported the proposal to limit those firms or individuals wanting to be described as ‘independent advisers’ to firms or individuals holding themselves out as offering advice across the whole market and offering the option to pay by fee.
20. There was also the alternative suggestion that use of the term ‘independent’ should be prohibited and advisers should rather compete on the basis of quality of advice, cost of advice, scope of advice and range of products.
21. Interestingly, most respondents cited consumer confusion as a reason for both lifting – and limiting – the restriction on the use of the term ‘adviser’. Respondents highlighted the risk of consumers associating ‘adviser’ with whole-of-market advice, and that therefore the disclosure rules would need to ensure clarity in this respect.
22. Enhanced and clear disclosure was seen as key to preventing consumer confusion, and respondents recognised the obligation to describe status in a manner which is clear, fair, and not misleading.
23. It was also widely suggested that we should consider an industry-wide common vocabulary to describe the different activities involved in giving advice. Respondents believed this was important as lifting the restrictions would lead to many ‘descriptors’ for financial advisers which would lead to confusion. It was felt that this would be of value to both the industry and consumers alike, as consumers would readily be able to distinguish between the categories of firms (independent, single-tied, multi-tied firms).
24. A few respondents specifically suggested that a consumer education campaign would contribute significantly in helping consumers to recognise the difference between factual information and advice.

**Our response:** We do not think that it is necessary or desirable to invent new ‘descriptors’ for the new and varied types of business model that we envisage emerging under depolarisation. A firm’s service will be described in the initial disclosure document (IDD) provided to consumers. Further than this, we do not believe that classifying firms adds any value.

Additionally, we believe there are no rational or reasonable grounds on which to restrict the term ‘adviser’ to some individuals and not allow it for others who are also giving advice.

We do not propose restricting the term ‘adviser’. In this regard, we again refer firms to their obligation to pay due regard to the information needs of their clients, and to communicate information to them in a way which is clear, fair and not misleading.

Allied to this, however, is a point of practicality which we have now accommodated in the draft rules. A firm that advises an employer on the choice of a group personal pension scheme may well be acting independently. Once the chosen scheme has been selected, the firm will then be engaged in enrolling employees of the company into the scheme, and even advising new scheme members on the merits of joining their employer’s scheme. This raised the issue of whether the firm would have to suppress its independent status in any disclosure material provided to customers even though it was only offering employees the opportunity to enrol in the chosen group personal pension. We do not want to put firms to the expense of changing all their stationery, business cards, and perhaps even trading name for this one line of business. Nor do we want firms to purport to be offering employees ‘independent’ (or whole-of-market) advice and the option to pay by fee simply to circumvent the need to have a different set of stationery, for example. So, we now propose to allow a firm which holds itself out as independent to use its standard stationery in a group personal pension situation. However, in such a situation it would have to include a statement in the IDD. This would be to the effect that when enrolling employees in the group personal pension, the firm would be dealing only with the company it had selected for the employer, and it could not advise on any other specific investment product in that meeting.

### **The submission that the draft rules on suitability will maintain the same comparative standard of advice following depolarisation**

25. Currently the general standard of advice requires all firms to make suitable recommendations, having regard to the customer’s circumstances. Where advisers have access to different brands of a product type, the most suitable product that meets the consumers’ needs must be recommended. In addition to this, a more specific standard of advice applies to provider firms. This states that the adviser must recommend the most suitable product from the available range – ‘best advice’. If no available product can be recommended as being suitable, no recommendation can be made. This standard is super-equivalent to the Insurance Mediation Directive (IMD).
26. **We asked:** Do you agree that the proposed rules on suitability will maintain the same comparative standard of advice following depolarisation?
27. A three-quarter majority of respondents were supportive of maintaining the same comparative standard of advice in a depolarised environment. There

was, however, much concern expressed (here, and in responses to other questions) about the out-of-range proposals.

28. Some respondents thought that we should use the opportunity depolarisation presents to redefine 'suitability' (to harmonise it with the Investment Mediation Directive standard being used for general insurance). They claimed that this would help to address industry concerns about 'mis-selling'.
29. A few respondents objected to our prohibiting product providers from imposing quotas on intermediaries. Among those who supported the prohibition, there were a few who doubted that the suitability obligation on intermediaries would be an effective means of stopping providers from imposing quotas.
30. Some respondents suggested that we should have made clear in the CP how the standards of advice would be modified in the light of the introduction of stakeholder products.

**Our response:** The implications of maintaining this standard of suitability for those firms that in future will act as distributors is that product providers will not be able to set quotas for distributors. This is because doing so would conflict with the regulatory obligation on the distributor to recommend the most suitable product to a particular customer. So, it will not be possible for a distributor to comply with the 'most suitable' requirement where it has recommended a product that is not the most suitable (for a particular customer) purely to meet a quota imposed by the firm whose products it distributes.

Firms will disclose to their customers both the scope and the range of products on which they are prepared to advise. There may be circumstances where it would be to the advantage of the customer that the firm, providing it is competent to do so, goes outside of its normal scope and range. For example it might be appropriate to do so for rate-driven contracts, such as annuities and term assurance.

In allowing out-of-range recommendations we made clear that these would be an option available to firms, not something they would be obliged to operate. If a firm wishes to permit its advisers to make out-of-range recommendations, it needs to have the systems and controls in place to ensure that it can vouch for the suitability of such recommendations made by its advisers.

In relation to the modification of the standards of advice in the light of the introduction of stakeholder products, this is an issue that we will consider in a later separate CP on a selling regime for simplified products.

Overall, the responses to this question gave no reason for us to suggest any significant change in the approach to the advice and suitability requirements set out in CP166. However, we have accommodated some purely technical points in the drafting of the rules that were identified by respondents.

## **The proposals requiring holdings in or credit to whole-of-market intermediaries to be at arm's length; and the abolition of the 'better than best' rule**

31. In CP166 – and subject to the current prohibitions on unfair inducements – we put forward a requirement that holdings in or credit to whole-of-market intermediaries should be at arm's length. This was so that such holdings or credit could not be used to undermine the independence of the intermediary. We acknowledged that this requirement to be strictly on commercial terms created difficulties for corporate groups.
32. More generally on product provider investment in intermediaries, we proposed abolishing the present 'better than best' rule and replacing it with a more proportionate and effective means of addressing the perceived risk (consumers are not protected against conflicts of interest and loss) arising from investment in a firm.
33. The 'better than best' rule requires that, when an independent adviser makes a personal recommendation to a customer to buy a packaged product offered by a 'connected product provider', it does so only where that product is more suitable than – rather than simply 'as suitable as' – any other packaged product generally available.
34. To support the abolition of the 'better than best' rule, we proposed the following safeguards.
  - The IDD should be used to disclose a significant connection (a financial link of 5% or more) with a connected product provider firm whose products may be recommended. This is super-equivalent to the provisions of the IMD which requires such disclosure from 10%.
  - Firms will be required to repeat in the suitability letter that, where it is the case, they have a significant connection with the provider whose product is recommended.
  - The current requirement on intermediaries to report to the FSA where 20% or more of its business is placed with a particular product provider will be continued, but rationalised.
35. **We asked:** How can the requirement for holdings in or credit to whole-of-market intermediaries to be at arm's length be relaxed for corporate groups – without creating consumer detriment or an unfair advantage over firms not in groups?
36. This question was an open question, so we did not expect specific support or disagreement, but rather opinions and suggestions. This section of the paper drew a fair amount of comment and, in the light of points made, we have now proposed some adjustment of the policy set out in CP166.

37. Generally, respondents supported capital investment in intermediaries recognising that it would create market efficiencies which would ultimately benefit consumers.
38. Respondents generally welcomed the removal of the ‘better than best’ rule. They felt that the proposed safeguards were ‘a practical substitute for the existing regime’ where ‘disclosure and transparency are the best approach to demonstrating links between the provider and IFA’.
39. It was also pointed out that the requiring of holdings in a corporate group’s intermediary to be on commercial terms is an internal financial management decision that need not be constrained by client suitability issues: the remaining safeguards should be enough to protect the quality of the advice.
40. Most respondents felt that firms should be free to distribute their own products, as well as those of any other firm. This is provided that the circumstances behind any connection are clearly disclosed to the consumer, and the existing unfair inducements rules are rigorously applied.
41. Whilst agreeing that consumers should be made aware of significant investments in intermediaries, several respondents questioned whether we had provided sufficient argument for proposing super-equivalence to the IMD, preferring the adoption of the 10% IMD threshold.
42. Respondents also generally agreed with the proposal for continuing monitoring of business placement. However, some respondents pointed out that there would be instances where firms are tied to only a few (say four) providers. In these cases, each provider could reasonably and legitimately expect a market share in excess of the 20% trigger, but this would nevertheless initiate an unnecessary regulatory paper chase.
43. A few respondents remained opposed to abolition of the ‘better than best’ rule and were reluctant to accept that the variety of safeguards that we have put in place would work to avoid investment in intermediary firms leading to the undermining of independence. However, the majority of respondents were satisfied that we had proposed a robust set of controls to avoid the perceived risk.

**Our response:** The argument in favour of applying the requirement for holdings in or credit to whole-of-market intermediaries to be at arm’s length (on commercial terms) was that these firms hold themselves out as providing unbiased, independent advice. However, it may be the case that some customers might not want whole-of-market advice, and may instead seek advice from a firm which offers products from a limited number of providers only. These customers should still be assured that the firm has no bias towards one of these providers. We also recognise that the requirement would create a perverse incentive for whole-of-market intermediaries to give up that status and start offering a more restrictive choice to their customers – as it would allow all other types of intermediary firms to obtain ‘sweet’ inducements from product

providers. It would also undermine the integrity of commission disclosure. So, we now propose that the requirement should apply to all types of intermediary firm.

We have therefore provided (in draft rule COB 2.2.5AE(1)) that the restrictions imposed on holdings in or credit to firms should not apply between companies which are members of the same immediate group. However, it is not realistic to expect companies that are members of groups to do business at arm's length from one another. This will mean, in effect, that where a product provider has less than a 50% holding in an intermediary, then any arrangement must be at arm's length.

Below the 50% limit there should be other shareholders in the intermediary who will have an interest in ensuring that arrangements are made on a commercial basis. Above the 50% level the product provider will be in a controlling situation and so here we would require disclosure of the value of any arrangement to be included in the commission disclosure figure made by the firm.

We considered the various arguments against super-equivalence with the IMD in relation to when a firm should disclose in its IDD that it has a connection with a product provider. Taking into account the potential additional administrative burden, a 5% disclosure requirement may not in reality indicate any level of control or influence that a shareholder or individual may have over a private company. It is also important for the UK to maintain its competitive position. So, we now propose adopting the 10% IMD trigger. This change will also carry through to the suitability letter in relevant cases.

The reporting requirement (where 20% or more of its business is placed with a particular product provider) provides us with a means of checking the reasons given by the intermediary for the placement of that business. It is not an outright prohibition.

### **The proposal to allow appointed representatives to have different ranges of products from their principals**

44. Under the current polarisation rules, ARs that give advice on packaged products must be either the AR of a single product provider (or of a number of providers within a marketing group) or the AR of an authorised independent intermediary.
45. However, removing the polarisation restrictions will mean that instead of restricting authorised persons to the two categories (of IFAs and single-tied firms), there will be a variety of different business models offering different ranges of products. It may be that consumers will not be aware of the difference between what was offered by the principal and the AR. This can be adequately addressed by full disclosure to customers of the range of products offered by the AR, before any advice is given.
46. We proposed removing the general requirement that every AR must offer for sale all of the products in their principal's range. Instead, the principal firm must agree with its AR both the scope of advice to be given by the AR, and

the range (or ranges) of packaged products on which the AR is to advise. This may be the entire range, or a sub-set of it, or a wider range than that offered by its principal. In all cases the principal would have to take responsibility for any advice given by the AR.

47. As far as out-of-range recommendations are concerned, a principal firm will not be obliged to permit its ARs to make out-of-range recommendations. This is a matter to be left to individual principals to agree with their ARs. Principals may disallow such recommendations, or allow such recommendations in certain circumstances only. However, if ARs make out-of-range recommendations, then their principal must take responsibility for their advice.
48. **We asked:** Do you agree that our proposal to allow ARs to have different ranges of products from their principals is the most effective way of liberalising the arrangements for advice and sale of packaged products by ARs?
49. This question drew the most opposition, although generally the majority of respondents remained in favour of the proposal suggested. Many respondents (and not just those opposed) cited consumer confusion and increased monitoring and compliance costs as likely consequences.
50. A few respondents mistakenly read it as a requirement that a principal must allow an AR to have a different range.

**Our response:** We are not making it a requirement that an AR be allowed to have a different range from its principal. It is an option – in the interests of greater distribution flexibility and wider consumer choice – which principals can make available to ARs should they wish to do so. If they do not wish to do so, then their contracts with ARs should specify this.

In practice, the arrangements may be mitigated both by commercial reality and principals being unlikely to want to take responsibility for business that is outside their own range. The open-ended compliance responsibilities, together with the enhanced training and competence and monitoring responsibilities, could be so great that, in practice, principal firms may want to limit the range of options their ARs can offer.

We see no case for changing the proposals allowing ARs to have different ranges of products from their principals. Allowing the option removes an unnecessary regulatory restriction.

### **The proposals on how firms should disclose key information on their services, and our intention to apply the IMD disclosure requirements to non-life packaged products**

51. In CP166 we noted that the IMD set out mandatory disclosure requirements that apply to firms doing general and life assurance business. We proposed

extending this application to all firms carrying on any packaged product business with private customers, and to implement the requirements through the use of the IDD. This is to avoid having different disclosure regimes, with different consumer safeguards, for life and non-life packaged products.

52. **We asked:** Do respondents agree with our approach to apply the IMD disclosure requirements to non-life packaged products in a similar manner to life packaged products?
53. This question drew the least comment. Over four-fifths of the respondents who answered this question agreed with our approach to apply the IMD disclosure requirements to non-life packaged products, stating that it appears sensible to have a single disclosure regime for packaged products.
54. Respondents generally appreciated that the approach was in the interests of consistency and clarity, given that consumers will often buy a basket of products from ranges consisting of both life and non-life products (for example, an interest only mortgage, life cover and an ISA). Respondents felt that the approach will minimise consumer confusion and facilitate potential cost savings for the industry.
55. However, respondents raised the concern that, when added to the product disclosure and status disclosure proposals, the amount of information required to be provided to consumers is increasing.

**Our response:** It makes sense for the disclosure documents for both life and non-life investments and mortgages to be as consistent as possible. Uniformity between the different disclosures will help to generate consumer confidence and understanding, as well as increasing the likelihood that the papers will be more widely read and understood.

We have addressed the 'volume of information' concern in the introduction to this feedback statement. Allied to this, however, is the fact that some of the additional information disclosure is mandated by various European directives, rather than being a matter of our choosing.

We see no need to change the proposals set out in CP166.

### **The proposal for an IDD**

56. Wider disclosure to customers before they conduct any investment business with a firm is one of the safeguards underpinning the new depolarised regime.
57. We developed the IDD alongside proposals for a similar document for mortgages (and originally for general insurance). We also intend to allow a combined version for those firms operating in a number of sectors. We have also had to take into account other developments that have had (and will have) a bearing on what a firm needs to disclose to a customer – for example, the IMD and, later, the Distance Marketing Directive (DMD).

58. **We asked:** Does the proposed IDD meet the key information needs of consumers?
59. Most of the respondents were in favour of the IDD and welcomed the approach which we had taken to focus on just the key information of crucial interest to potential customers. Respondents said that it would provide more meaningful and user-friendly disclosure to consumers which would ultimately enable them to make informed decisions (it will help consumers ‘shop around’ for the most suitable product).
60. Many respondents also agreed that the prescribed format will ensure that consumers become familiar with the document and that this will avoid confusion. However, there were many calls for it (when read alongside the menu) to replace the terms of business letter, as there should be no duplication of information throughout the buying process. In this regard, most respondents were also keen to see consistency across the different market sectors, although recognising that the levels of service in each may be different.

**Our response:** The IDD tells the customer such things as whether or not the firm is giving advice from across the whole market or represents just a single product provider. Recognising that the IDD should include meaningful detail, our focus nevertheless has been to minimise the volume of information provided and to focus on the key information needs of consumers. So, the IDD is short and punchy and expresses concepts in language which ordinary consumers can understand. The concept worked well when it was consumer-tested.

We do not propose requiring firms to list the names of the companies with which a firm deals, the basis on which the firm decided to deal with those companies, and the names of the products which the firm might recommend. This will make the document lengthier, more complex, unwieldy and would destroy the simple messages which we are trying to convey about the services on offer from the firm. If, for example, a firm had to list the names of 15 fund managers, 6 life offices and 2 friendly societies with which it had regular dealings, and then explain why it was that the firm had decided to select those particular companies it would lead to a document running to several pages and this would arguably be of little use to customers. Additionally, requiring such information would be super-equivalent to the IMD, which simply requires a list to be given on request.

As a result, we consulted in CP166 on the basis that the IDD would give a prompt to the customer to ask for a list of the companies and products with which the firm deals should the customer wish to have that information. We also proposed obliging the firm to be prepared, on request, to explain the basis of its selection of those companies and products.

There is no obstacle to a firm volunteering any or all of this information, but, if it does so, it will have to do it separately from the IDD so as to ensure that the short, key messages in that document are not obscured.

We have amended the draft rules to give firms the option of attaching the terms of business to the IDD to form a single document so that firms need not duplicate required information. However, such information would have to follow and not detract from the prominence of the information required in the IDD.

We have reconsidered our policy for draft rule COB5.1.3R. Firms will be required to disclose the scope of advice to be provided. They will then be expected to complete the advice process by selecting the best product from the scope disclosed. In this regard, consumers would be clear as to what they were being offered. The disadvantage is that consumers could not be offered a product from outside the initial scope, if it became clear during the advice process that this would be more suitable for their needs. So, we enabled firms, as an exception to the general rule, to permit their advisers to change their original scope, but only if the move was from a narrower to a wider scope i.e. in the direction from advising on the products of a single provider, to the products of a number of providers, through to advising across the whole of the market. We still believe that our general approach in this area is correct, but it has become apparent that the exception we provided does not go far enough.

For example, if a firm began by giving advice on a range of products from providers A and B, but during the advice process it became clear to the adviser that the range should be expanded to include the products of providers C and D as well, he could not do so, as this possibility was not provided for in CP166. However, if we allowed this, it would not involve any change of scope, because the firm will still be advising on a 'limited number of product providers', despite the fact that there may be a greater number of providers. In our view there is no difference in principle between allowing a firm to move from a narrower to a wider range, and allowing a move from a narrower to a wider scope. If the one scenario is permitted, then the other should also be allowed. So, we have amended our draft rules to make both possible.

We do not propose materially changing the proposed IDD. However, we have rearranged some of the material since the version published in CP166.

### **The proposals for complaints to be dealt with as efficiently as possible by facilitating a single point of entry to the process**

61. Under depolarisation we want to enable consumers to be able to lodge a complaint with any relevant firm without having to re-submit the complaint should a different firm be responsible for dealing with it. The nature of a complaint and the status of the adviser will determine who is responsible for dealing with it. The lines of accountability will broadly follow the principle of the advising firm taking responsibility for the advice, the product provider for the product, and administration issues will depend on where the issue arises.
62. CP166 proposed that the IDD (or terms of business) would point consumers to the firm that advised on or sold the product, as the initial point of contact

for complaints. Once a firm has received a complaint, it will assess whether the issues relate to its own responsibilities or those of another firm.

63. There will be some crossovers where more than one firm is potentially at fault. If the receiving firm has reasonable grounds to believe that another firm is at fault, then it will be expected to refer the complaint on to that firm. It will also need to inform the customer in its response about why it does not consider the complaint is relevant to them. Where the firm initially receiving the complaint is also partially responsible, it should refer the complaint on, with the relevant update being sent to the complainant, and continue to deal with its own issues.
64. **We asked:** Do you agree that the proposed rules regarding the referral of complaints implement the intention for complaints to be dealt with as efficiently as possible by facilitating a single point of entry to the process?
65. Nine-tenths of the respondents who answered this question agreed that a single point of entry into the complaints process would facilitate efficient complaints handling and that it was a pragmatic way forward. Many respondents agreed that the proposed single point of entry would help to eliminate consumer confusion. Many respondents also stated that it is likely to speed up the complaints process, as it will be in firms' interests to pass misdirected complaints on as swiftly as possible.
66. Many respondents called for the rules to be sufficiently robust to prevent firms from evading their responsibilities by placing fault with the other party. To avoid complaints falling through a gap – with customers being referred back and forth between one firm and another – respondents felt it was important to ensure that customers are fully aware as to who is responsible for what at the outset.

**Our response:** Some respondents suggested useful drafting suggestions, which we have adopted. In particular, firms that first receive complaints, as well as firms to which complaints are referred, will be required to inform the consumer that this has been done. So, for example, if firm A has reasonable grounds to believe that firm B is solely at fault, then firm A must refer the complaint to firm B promptly; and tell the complainant by way of final response. If firm A has reasonable grounds to believe that firm B is jointly at fault, firm A must refer the complaint to firm B promptly; tell the complainant; and (maybe later) issue a final response.

### **The proposal to extend the guidance on 'reasonable' indirect benefits to include items such as computer facilities or IT support**

67. Current guidance makes it possible for intermediaries to have non-disclosed 'reasonable' indirect benefits. The guidance is designed to ensure that firms can accept benefits which can reasonably be regarded as benefiting customers without the need to value the benefits and disclose them alongside commission disclosure.

68. We want to extend the same principles into the new regime so that it covers all types of intermediary firm which represent more than one company. In addition, we suggested in CP166 that given the technological advances since the reasonable indirect benefit rules were introduced there might be a case for allowing IT facilities or IT support to be a permitted and non-disclosable benefit for all intermediaries where there will be benefits for the end consumer (efficiency). The cost savings made as a result of this increased efficiency could ultimately flow through to benefit the end consumer. However, we noted that the provider of the technology could design it to be incompatible with other providers, and so effectively limit choices for the consumer. So, any relaxation of the current requirements on IT provision would need to be coupled with some safeguards.
69. **We asked:** Should the guidance on ‘reasonable’ indirect benefits be extended to include other items such as computer facilities or IT support?
70. Over two-thirds of the respondents who answered this question were in favour of extending the guidance on ‘reasonable’ indirect benefits in this way, recognising that this would ‘bring distribution capabilities into the 21st century.’ These respondents felt, therefore, that this would necessitate us providing updated and more detailed guidance which would make it clear what is acceptable within the constraints of the indirect benefit rules.
71. Respondents generally agreed that the benefits of greater technology adoption would ultimately filter through to consumers in the form of better products and enhanced service. However, many respondents also anticipated that this might create a conflict of interest or source of bias. There was the general concern that without appropriate controls, relaxation of current rules in relation to computer facilities and IT support could be abused and lead to non-disclosure of significant financial subsidies from producer to distributor.
72. There was support for our preference not to have a defined list of indirect benefits (which could be used as a ‘monitoring checklist’), but to rather use generic guidance. However, it was pointed out that this would increase the likelihood of larger companies extending the rules beyond their original intention. In particular, it was stated that as IT support could always be justified as increasing process efficiency, smaller firms would be disadvantaged.
73. Many respondents cautioned against this being an allowable benefit because they perceived a significant danger that this proposal would distort the market, as larger providers would expect volumes of business in return for IT support (i.e.: it could facilitate ‘volume override’). Respondents cautioned that if this issue is not properly addressed, there might be a serious risk of the market being distorted by anticompetitive practices, which could act against innovation in the market and cause significant difficulties for new entrants.

**Our response:** We want to extend the same principles into the new regime so that it covers all types of intermediary firm which represent more than one company. We have taken the view that there is a difference between product providers contributing towards IT systems that have no connection to their business – which is no more than a form of subsidy – and contributions to systems that genuinely assist both the provider and the beneficiary. So, we are proposing to amend the current requirements by extending the guidance to the effect that a product provider may only pay cash amounts, or give assistance, to the development by another firm (which is not in the same immediate group) of software or other IT facilities to the extent that the provider can identify equivalent benefits (cost savings) to itself or to the customers of the other firm.

Our proposals are consistent with existing rules and principles (Principles for Businesses 1 and 8) which require a firm not to conduct business under arrangements that might give rise to a conflict of interest with its duty to customers.



# Examples of the menu documents



# A guide to the cost of our services

Last updated 26 February 2004

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ABC Financial Services plc, 123 Any Street, Some Town, ST21 7QB

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## 1. The Financial Services Authority (FSA)

The FSA is the independent watchdog that regulates financial services. It requires us to give you this document. Use this information to shop around and decide which firm to use.

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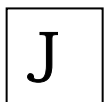
## 2. Our services

We offer an initial meeting without charge when we will describe our services more fully and explain the payment options. If you decide to go ahead, we will:

- € gather and analyse personal information about you, your finances, your needs and objectives;
  - € recommend and discuss any action we think you should take and, with your agreement, arrange relevant investments for you.
- 

## 3. What are your payment options?

Not all firms charge in the same way. We will discuss your payment options with you and answer any questions you have. We will not charge you anything until you have agreed how we are to be paid. **We have ticked the payment options we offer.**



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**Paying by fee.** Whether you buy a product or not, you will pay us a fee for our advice and services. If we also receive commission from the product provider for selling you a product, we will reduce the fee; or increase the amount invested; or refund the commission to you.



**Paying by commission (or product charges).** If we sell you a financial product, we will normally receive commission on the sale from the product provider. Although you pay nothing up front, that does not mean our service is free. You still pay us indirectly through product charges. Product charges pay for the product provider's own costs or any commission. These charges reduce the amount left for investment. If you buy direct, the product charges could be the same as when buying through an adviser, or they could be higher or lower. We will tell you how much the commission will be before you complete an investment, but you can ask for this information earlier.

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## 4. How much might our services cost?

We will agree the rate we will charge before beginning work. We will tell you if you have to pay VAT.

Our typical charges are:

Principal/Director/Partner	<b>£150-200 per hour</b>
Financial adviser	<b>£100-150 per hour</b>
Administration	<b>£25 per hour</b>

You can ask us for an estimate of how much in total we might charge. You can also ask us not to exceed a given amount without checking with you first.

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## 5. Further information

If you need any more help or information ask your adviser or:

- € visit [www.fsa.gov.uk/consumer](http://www.fsa.gov.uk/consumer); or
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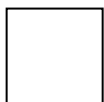
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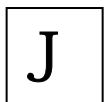
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## 4. How much might our services cost?

Tables 1 and 2 show examples of the amount of commission we would receive (or the equivalent we earn through product charges) and compare that with the market average (see notes 1 & 2 at the end of this section 4).

The amounts vary according to the type of product, the amount you invest and (sometimes) for how long you will invest or your age when you start the product. We will confirm the actual amount to you before selling you a product.

**Table 1 - Commission if you pay monthly**

Monthly Products	Example term or age	Comparison of costs		An example based on £100 per month
		<i>Our maximum</i>	<i>The market average</i>	
				<i>This column shows the maximum our sales and advice costs would be for a monthly investment or premium of £100, ignoring any increases through fund growth</i>
<b>Collective investments (e.g. unit trusts)</b>	Any	<b>3%</b> of all payments	<b>1.67%</b> of all payments	<b>£36</b> each year
<b>Endowments</b>	10 year term	<b>40%</b> of your first 12 payments then <b>2%</b> of all payments from month 17	<b>40%</b> of your first 12 payments then <b>2%</b> of all payments from month 17	<b>£480</b> initially plus <b>£24</b> per year from month 17
<b>Whole of life assurance</b>	Age 40	<b>90%</b> of your first 12 payments then <b>2.5%</b> of all payments from month 48	<b>60%</b> of your first 12 payments then <b>2.5%</b> of all payments from month 48	<b>£1 080</b> initially plus <b>£30</b> per year from month 48
<b>Long term care protection</b>	Age 65	<b>95%</b> of your first 12 payments then <b>2.5%</b> of all payments from month 39	<b>90%</b> of your first 12 payments then <b>2.5%</b> of all payments from month 39	<b>£1 140</b> initially plus <b>£30</b> per year from month 39
<b>Personal and Stakeholder Pensions</b>	25 year term	<b>6%</b> of your first 24 payments, then <b>0.25%</b> of your fund each year	<b>4.67%</b> of your first 24 payments, then <b>0.25%</b> of your fund each year	<b>£144</b> initially plus <b>£7.50</b> in year 3, <b>£10.50</b> in year 4, and so on (The actual amounts in later years will vary in line with your fund growth)
	10 year term	<b>6%</b> of your first 12 payments, then <b>0.25%</b> of your fund each year	<b>4.67%</b> of your first 12 payments, then <b>0.25%</b> of your fund each year	<b>£72</b> initially plus <b>£4.50</b> in year 2, <b>£7.50</b> in year 3, and so on (The actual amounts in later years will vary in line with your fund growth)

**Table 2 - Commission if you invest a lump sum**

Lump sum Products	Example term or age	Comparison of costs		An example based on £10 000 lump sum
		<i>Our maximum</i>	<i>The market average</i>	
				<i>This column shows the maximum our sales and advice costs would be for a lump sum investment of £10 000, ignoring any increases through fund growth</i>
<b>Collective investments (e.g. unit trusts)</b>	Any	<b>4.2%</b> of the amount you invest plus <b>0.25%</b> of your fund each year after the first	<b>4.0%</b> of the amount you invest plus <b>0.25%</b> of your fund each year after the first	<b>£420</b> in year 1 plus <b>£25</b> each year afterwards (The actual amounts in later years will vary in line with your fund growth)
<b>Investment Bond</b>	Any	<b>7%</b> of the amount you invest	<b>5.9%</b> of the amount you invest	<b>£700</b>
<b>Long term care</b>	Any	<b>3%</b> of the amount you invest	<b>2.7%</b> of the amount you invest	<b>£300</b>
<b>Annuities</b>	Any	<b>1.5%</b> of the amount you invest	<b>1 %</b> of the amount you invest	<b>£150</b>
<b>Income drawdown</b>	Any	<b>5%</b> of the amount you invest plus <b>0.5%</b> of your fund each year after the first	<b>4%</b> of the amount you invest plus <b>0.5%</b> of your fund each year after the first	<b>£500</b> in year 1 plus <b>£50</b> each year afterwards (The actual amounts in later years will vary in line with your fund growth)
<b>Personal and Stakeholder Pensions</b>	Any	<b>0.3%</b> of your fund in each year	<b>0.35%</b> of your fund in each year	<b>£30</b> each year (The actual amounts will vary in line with your fund growth)

**Notes:**

1. The market average figures are estimated by the FSA using actual figures from a representative sample of regulated firms and are shown in a way that you can compare with our own maximum rates.
2. Where a firm sells its own products it must calculate its figures according to FSA guidelines.

## 5. Further information

If you need any more help or information ask your adviser or:

- € visit [www.fsa.gov.uk/consumer](http://www.fsa.gov.uk/consumer); or
- € call the FSA helpline on 0845 606 1234.



# Background to the current commission disclosure regime and policy alternatives to the menu

## Commission disclosure

1. Government, industry and regulators have had concerns about the potential for upwards bidding of commission since before the start of the Financial Services Act (FSAct) regulatory regime in 1988. In 1988, the mechanism of choice was a combination of a Maximum Commissions Agreement (MCA) and a ‘soft’ disclosure regime, and one which in the then newly polarised world, applied only to IFAs. The MCA did not last long, however, due to a ruling by the European Commission that the combination of the MCA and soft disclosure would be considered illegal (breaching the competition requirements of the Treaty of Rome) and disclosure of the actual commission received by IFAs quickly replaced it.<sup>1</sup> The commission disclosure only normally appeared in the post-sale confirmation, was expressed only in percentage terms, so it did little to engage consumers’ attention and frequently went unnoticed.
2. During 1994/5, the regime was further amended after the Chancellor of the Exchequer had directed SIB and Lautro to change the rules to require firms to disclose earlier in the sales process, and in cash (not percentage) terms, the amount of commission receivable on a transaction. And, for the first time, the regulators were required to devise an equivalent form of disclosure for non-independent advisers. The disclosure of this ‘commission equivalent’<sup>2</sup> for the tied sector took account not only of their direct sales incentives receivable as cash, but also of the value of other benefits and services provided by the principal (such as company cars and administrative support). This was because an IFA would be constrained by rules banning the receipt of ‘indirect benefits’ from product providers, and would have to meet similar costs out of its commission receipts. This effectively placed a value on the separate service of giving advice by all types of adviser; and disclosure to consumers gave them the potential to negotiate over price.

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1 ‘Lautro A Pioneer regulator 1986-1994’ Kit Jebens CBE.

2 The terminology used in the rules for commission equivalent is currently ‘remuneration’. This CP proposes reverting to ‘commission equivalent’.

3. The ‘commission equivalent’ figure for non-independent advisers relies on a relatively complex combination of rules and actuarial guidance that require firms to assess the costs and apportion them across the range of products to achieve a comparable figure that is as fair as possible. Our rules detail the expenses that must be included in the calculation, and we give guidance on the calculation of commission equivalent figures in Guidance Note (GN) 22, which is issued by the Institute and Faculty of Actuaries. GN22 has not been updated since 1995.
4. The current regime requires a customer-specific amount to be stated, so disclosure cannot take place until the adviser has recommended a specific product. Consequently, disclosure of the cost of advice currently takes place very late in the sales process and at a point when it is unlikely to influence consumer behaviour. In practice, the disclosure is often made at the end of the product key features document.
5. In summary, the objectives behind the commission disclosure rules are to show consumers that an adviser or his firm has a monetary interest in the selling of a product, the size of that interest, and whether there is any company, product or term bias.

### **Effectiveness of the current regime**

6. As stated above, the current disclosure takes place at the end of the sales process. During the polarisation review, we carried out a number of pieces of research that bear on the issue of the ‘cost of advice’. In summary, the research has shown that:
  - many consumers still think of advice as a free good and do not appreciate that the cost is ultimately met from the charges that the provider takes on products purchased by consumers;
  - there is a marked reluctance to pay fees for advice, and even where consumers would consider paying a fee it would generally not be a realistic amount;
  - there is some evidence of commission-based advice leading to consumer detriment, as shown by the analysis carried out for us by Charles River Associates based on an economic analysis and mystery shopping exercises;
  - there is little shopping around for advice by consumers and not a great deal of negotiation with advisers to see if any commission can be rebated to improve the contract terms for the customer;

- because consumers do not relate such costs to product charges and performance, the impact of commission on the performance of their investments is not widely understood.
7. We have concluded from this that some of the key disclosure messages need to be strengthened and that consumers need to be given these messages earlier in the process when they have more opportunity to use the information. In developing the menu concept, this research informed our objectives for improved disclosure.

### **Alternatives to the menu**

8. In October 2002, we announced that to meet our objectives of reducing the potential for commission bias, making consumers more aware of the cost of advice, and facilitating shopping around, we would no longer pursue the defined payment system (DPS). Instead, we decided to develop the menu concept suggested to us by AIFA/IFAP in their response to CP121. We have maintained a dialogue with the major trade bodies and other stakeholders, and have considered a number of other alternatives that have been put to us with the common theme of bringing disclosure to the beginning of the advice and sales process.
9. The main options that we considered as alternatives to the menu are set out below.

#### *Defined Payment System (DPS)*

10. This would have applied only to the independent sector and required the firm to act for the consumer purely on a fee basis, although one possible way in which the fees could be collected was to offset them against (and account to the consumer for) commission receipts. An independent firm would not have been permitted to keep commission for its own benefit.
11. This option provoked a significant amount of comment in the responses to CP121. It also met with opposition from the IFA sector and consumer groups alike, with both sides arguing for the retention of an option to choose to pay for advice through the commission route. The DPS would have applied only to those wishing to hold themselves out as independent. So, in not applying to tied or multi-tied firms, it would have created a two tier system, which could lead some consumers to believe that IFA advice came at a cost, whereas a more restricted offering appeared free. The responses indicated that this option could result in significantly decreased availability of independent advice. While the relative cost benefit analysis work carried out for us by NERA did suggest there would be some benefits to the DPS, it also indicated that the menu option should deliver greater benefits at lower cost.

### *Unbundling*

12. In addition to DPS, CP121 also proposed to tackle the transparency of the cost of advice more generally and canvassed the idea of ‘unbundling’ the cost of advice from the cost of the product. We proposed applying this measure to all sectors of the market. We suggested this could involve point of sale disclosure of three separate elements: (i) the charges paid for the product alone excluding advice (ii) the cost of advice, and (iii) the total combined price for the product plus advice, and we asked respondents to say how best the separation of costs could be achieved. Unfortunately, neither we nor respondents were able to identify a practical and cost-effective method of unbundling costs in a way that would be meaningful to consumers and likely to have an impact on consumer and market behaviour.

### *Sandler tariff sheet*

13. In his report on savings in the UK published in July 2002 (*Review of Medium and Long-Term retail Savings in the UK*) Mr Ron Sandler proposed an approach to disclosure that would involve an adviser handing a customer a ‘tariff sheet’ at the start of the sales process setting out the adviser’s charges for various services and/or transactions. The customer and adviser would then make an explicit agreement about the payment made to the adviser without any provider involvement. Sandler suggested that this approach had two major advantages: it would be much more difficult for commission bias to operate, and the customer would clearly be able to see that they were purchasing a distinct service of advice.
14. This option was included in the comparative cost benefit analysis work carried out for us by NERA. That work showed that, although there could be significant benefits, this would probably be the most costly to implement as it would require some form of authorisation from the consumer to the provider for the fee to be paid by instalments or taken from the investment to pay for the advice. There would also be substantial costs of system changes for both providers and advisers. The NERA work suggested, therefore, that this approach would have a less favourable cost-benefit balance when compared to the menu.
15. Further, this approach would again create disparity between the independent and tied sectors and could potentially lead to a reduction of the IFA sector.

### *A menu based on product charges*

16. A strong argument from the banking sector, in particular, centres on the premise that total charges and their effect on the customer’s investment are uniquely important, and that, subject to having other rules in place aimed at avoiding commission bias, it is irrelevant how much the advisory firm or the adviser actually gets paid. This is based on the fact that some organisations

will be able to negotiate with providers for higher commissions than other intermediaries within the same level of product charges. But this fails to take account of the fact that the Treasury direction to the SIB and Lautro were targeted specifically at the sales incentive rather than the product charges. It would also leave unanswered the recommendation in the DGFT's 1989 report that the FSA should consider whether more could be done to improve transparency about the cost of advice.

17. The original work of the AIFA/ IFAP working party on the menu looked at a menu based on total charges. We have also considered basing the disclosure on a measure such as reduction in yield. However, there are a number of potential problems with such an approach. First, consumers have only a very limited understanding of measures such as reduction in yield. Differences in figures will often look quite small e.g. 0.5%, whereas the effect on the outcome of an investment based on that difference could be significant.
18. If commission is not disclosed in addition to charges, then the customer has no means of deciding whether the firm offers a value for money service or if there is any scope for negotiation. Creating a menu based on charges alone does little to combat commission bias which is one of the main objectives of introducing the new disclosure regime.
19. Currently, the disclosure of the total charges on a product are made in the Key Features document. This information is handed to the consumer after the adviser has recommended a product from a specific provider as being suitable for the consumer. We believe that disclosure of product information including the disclosure of total product charges can be improved and we have consulted separately on this.
20. This approach would mean that consumers would receive information about the total charges on products very much earlier in the process – effectively, in the first meeting with the adviser. Consequently, any disclosure would have to be on a specimen basis because, at the time the information is handed over, the adviser would not have gathered information about the consumer and would therefore not know which type of product would be suitable.
21. We have questioned whether the disclosure of indicative charges at this stage in the process would be of use to the consumer. Further, we do not consider that on its own, such disclosure would provide the consumer with all the important information. We would still have to require firms to disclose the commission that they are paid for recommending products. So, at best, total charges disclosure would operate not as a substitute for disclosure of information but rather as complementary, additional information.
22. The commission that providers pay to banks and other distribution channels has to be met from the charges that they levy on the product in question. So, the total charges on the product are likely to be higher than they need be for

all purchasers of the product to pay for the higher commission which the provider tends to pay to some of the larger or more powerful distributors.

23. For example, we permit differential pricing by providers so that where there are economies of scale in distributing a product through a particular channel, it is possible for a provider to reflect that in lower charges to the customer. There are some instances where providers seem to buy distribution through the commission which they are prepared to pay to the distributors. This is precisely the point which the menu is intended to address. We want consumers to focus on whether the service, rather than the product, they receive from a particular firm is justified by the commission that is being paid to that firm or whether they might do better by going elsewhere. This is not at the expense of the consumer also focusing on the total charges of any product that they are eventually recommended to buy, but is in addition to it.

#### *Cost Of Advised Sale – COAS*

24. A tied sector working group explored an idea for disclosing in a menu-type document the ‘Cost Of an Advised Sale’ (COAS), which would have applied to all sales channels. This idea was based on disclosing a higher amount for IFA sales to include costs to the provider of making a sale over and above commission or commission-equivalent. For example, a provider may incur the costs of employing broker consultants and their management structure to secure commission based business. Those costs are not currently disclosed. Adopting this approach would mean higher disclosures than at present for both independent and tied channels, such as bancassurers. While this idea had some merit, it would give rise to the need for some particularly complex disclosures, especially when business is transacted on nil commission terms for a fee. On balance, we considered the concept would be too complex for consumers to easily understand, and it might actually make it more difficult for consumers to negotiate with the firm. The complexity of the calculation could be problematic and lead to significant costs either remaining unallocated or being allocated on an arbitrary basis.
25. One aspect of the COAS-based menu was a proposal to include a statement explaining how the adviser would be ‘incentivised’ to make sales and, in particular, whether there were different incentives for volume or type of sales made. For instance, if the adviser was purely paid a salary, that fact would be stated. But if the adviser was to earn a bonus at a particular business threshold, additional detail would have to be given. Some of the bancassurers suggested that this limited disclosure about the adviser’s remuneration basis could substitute for disclosure of the commission equivalent amounts that apply to the firm. However, inconsistency would remain if firms were required to disclose commission receipts where their advisers are salaried only. Therefore, we do not believe that this proposal would be sufficiently effective to empower consumers to negotiate over the cost of advice, and to shop around.

# Market averages

1. In order to calculate and publish market averages to be included in the menu, we will need to collect and process data on commissions and commission equivalents from firms. We will have to calculate market averages taking account of the variety of commission shapes used in the market. So, we propose to use a series of discount factors and other assumptions. This annex sets out how we propose to do this.

## **Commission data to be collected**

2. We will need to collect basic commission and commission equivalent data from product providers. Because of the distinction the menu makes between commission-based and fee-based business, we propose to exclude business transacted on nil commission terms from the data we gather, as we assume that such business would, in practice, be fee-based.
3. We will specify the contracts to be included in each product group. For regular premium contracts, the premium paying term or age will also be specified to enable consistent figures to be obtained regardless of the firm's mix of business. However, we propose weighting the calculation of market averages by all of the firm's commission paying, regular premium business for that product group. Draft forms to be used for this purpose are included at the end of this annex.
4. These returns should enable market averages to be calculated based on commissions paid by the product provider. These figures will already reflect any amounts rebated to improve the product terms for the customer, but do not allow for rebates given by the adviser direct to the customer (for example, cash payments). Commission used to offset fees will be included.
5. We propose taking a sample of adviser firms. The sample would be selected to ensure coverage of larger firms. We would use this information to calculate the average effect of direct rebating in cash to the customer and adjust market averages accordingly. If the adjustment proves to be immaterial, we will review the relevance of this part of the process.

6. Table 1 below shows how this procedure might apply after the end of any transitional arrangements. Activities that we or firms are required to undertake are specified in this table.

Stage	Description
1	<p>We will specify, in the rules, the product groups to be included in the menu.</p> <p>We will specify the details of the example contracts for each product group. This may include specifying the term or age of the customer.</p>
2	<p>For each product group, adviser firms will have to disclose in the menu:</p> <ul style="list-style-type: none"> <li>(a) their own maximum rates of commission or commission equivalent (this will be disclosed in the shape that the firm typically expects to receive the commission);</li> <li>(b) the corresponding market average in the same shape as in (a);</li> <li>(c) the amounts of their own maximum commission for amount of the example premium and other conditions as specified.</li> </ul> <p>Any changes to the items specified in the rules will be subject to consultation.</p>
3	<p>We will specify the data to be supplied by product providers.</p> <p>Product providers must supply the required data to us. Participation will be voluntary for (i) non-directive friendly societies, (ii) firms with sales in the product group of less than 100, and (iii) firms closed to new business, except for customers who already have a contract with the firm.</p> <p>The requirements for data and reporting will include:</p> <ul style="list-style-type: none"> <li>(a) the period to which the data relates e.g. the business written in the three months ending on a specified date;</li> <li>(b) the date by which the data must be submitted, one month after the end of the period in (a);</li> <li>(c) for the product specified in each product grouping, their average commission rates for each commission shape based on the term or age specified;</li> <li>(d) for each product grouping, the total premiums for all ages and terms written during the period specified in (a) split between each commission shape.</li> </ul> <p>Product providers will be required to include commission equivalent figures in respect of packaged products sold by associated firms.</p>

	<p>Average commission rates are to be net of any commission rebated or reduced and applied by the product provider for the benefit of the customer.</p>
4	<p>For commission rebates arranged by adviser firms with customers, we will specify the data to be supplied by a sample of adviser firms.</p> <p>Adviser firms must supply the required data to us. The requirements for data and reporting will include:</p> <ul style="list-style-type: none"> <li>(a) the period to which the data relates e.g. the business written in the three months ending on a specified date;</li> <li>(b) the date by which the data must be submitted, one month after the end of the period in (a);</li> <li>(c) for each product group, the average rate of rebate they have given to the customer and which would not be expected to be reflected in data supplied by product providers (for example, cash rebates to customers, or increases in notional investment amounts would be included; lower commission in return for lower product charges would be excluded, as providers would report the net commission payable in those cases);</li> <li>(d) for each product grouping, the total premiums for all ages and terms written during the period specified in (a).</li> </ul> <p>The sample in 4 above would be chosen on a stratified basis to try and ensure that all types of adviser firms are proportionately represented.</p>
5	<p>In order to calculate the market average figures for the menu, we will:</p> <ul style="list-style-type: none"> <li>(a) Analyse the returns. If any of the figures appear to be inappropriate, we will refer them back to the firm and try and resolve the problem. If this cannot be achieved by the deadline, we may exclude such figures from the calculation of the average market rate.</li> <li>(b) Calculate average net present values (NPVs) of the commissions for each specified product; <ul style="list-style-type: none"> <li>(i) using the factors that have been published for this purpose;</li> <li>(ii) weighting by each firm's premiums or contributions reported in accordance with 3(d);</li> </ul> </li> </ul>

	<ul style="list-style-type: none"> <li>(iii) reducing by the average rebate (from data in 4 above) applied to the proportion of total business to which it applies;</li> <li>(iv) using the same factors in (i), to respread the average commission rates into the various commission shapes; and</li> <li>(v) rounding the resultant averages and apply checks before publishing a set of average market rates to be included in the menu.</li> </ul> <p>The rounding in (v) would be to the nearest 0.1% although we may allow to nearest 0.25% where this is used for the payment of commissions.</p> <p>(c) The checks referred to in (b)(v) above include:</p> <ul style="list-style-type: none"> <li>(i) determining whether the averages are reasonable and not distorted by maverick figures for example, the factors used in 5(b)(i) may no longer be appropriate due to changes in market practice or economic conditions;</li> <li>(ii) any other changes that we deem essential to enable fair and reasonable figures to be published.</li> </ul>
6	<p>We will publish the average market rates on our website and remind firms of this in suitable publications.</p>
7	<p>Adviser firms would have to include the new averages in their menus as follows:</p> <ul style="list-style-type: none"> <li>(1) if there are any changes which reduce the market average by more than 4% of the previous average, by not later than the date prescribed by us;</li> <li>(2) in all other cases, at the next time the firm has otherwise reason to change its menu.</li> </ul> <p>Firms will have a two month period from the date when we publish the new market averages to incorporate them in their menus.</p> <p>A reduction in the average from 3.5% to 3.4% would be 2.9%, and therefore not more than 4%; but a reduction to 3.3% would be 5.7% and therefore more than 4%.</p>

8	<p>The proposed timetable for years after 2004 is as follows:</p> <ol style="list-style-type: none"> <li>(1) 1 April to 30 June the relevant business period (as 3 (a));</li> <li>(2) By 1 August firms to submit their data (as 3(b) and 4(b));</li> <li>(3) By 1 November we are to publish new market averages (as (6));</li> <li>(4) By 1 January the following year adviser firms to include market averages in their menu where 7(1) applies.</li> </ol> <p>These dates are indicative. Business should relate to a calendar quarter to tie in with normal business reporting practices. 1 December is likely to be more convenient for implementation than 1 January. The timing in the first two years may be different depending on when the rules are made.</p>
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### **Principles behind calculation of market rates**

7. We propose to have a basis which equates the different commissions. The method would calculate the NPVs for each commission shape. Premium-related commissions for single premium contracts and indemnity commissions for regular premium contracts are paid on this basis. This means the amounts can be used without adjustment, but all other commissions would require adjustment to calculate NPV
8. The NPVs can then be used to calculate an average NPV. One option which we considered was to require firms to disclose the average NPV. This is not our preferred option as the customer would have difficulty in comparing the actual commission with a NPV average.
9. So, we propose that the average NPV should be re-expressed in terms of the actual commission shapes. Firms would be required to include the market average closest to its own commission shape. An example of this is in draft COB 4 in Appendix 1 of this CP.
10. To calculate NPVs, we will have to take account of five factors.
  - A net growth rate in order to assess the future size of the fund. We propose to simplify the calculation by using the mid-point monetary rate of return from current COB 6.6.51 less an arbitrary allowance of 1% for charges (currently this would be 6%).
  - A discount rate to allow for re-spreading of payments, especially to calculate NPV. We propose to use the net growth rate, plus factor (D%). The purpose of this is to equalise as far as possible the economic value of different commission shapes. D is proposed to be 3%.
  - A lapse rate to allow for the fact that for a proportion of cases, the contract will not be in force and no future commission will then be

payable. It would not be applied to indemnity commissions, but only in respect of amounts payable after the assumed lapse.

- An assumed term for open-ended contracts.
  - A further factor to allow for any other necessary adjustments.
11. These factors would be kept under regular review in order to minimise the risk of distortion between different commission shapes. This would take account of:
- current economic conditions;
  - the persistency experience of the relevant contracts, and
  - commission alternatives available in the market place.

*Factors proposed in calculation of market rates*

12. Table 2 below shows the factors to be used for products expected to be included in the menu. All rates are annual rates.

**Table 2: Proposed calculation factors**

Product	a) Discount rate	b) Net growth rate	c) Lapse rate (per annum)	d) Assumed term	e) Further factor
<b>Regular premium</b>					
<b>Life / endowment</b>	6 + D%	6%	6%	Maturity	
<b>Personal pensions / SHP</b>	6 + D%	6%	12% for 5yrs. then 5%	Maturity	
<b>Single premium</b>					
<b>Bonds</b>	6 + D%	6%	2.5%	7 years	5% regular withdrawals
<b>Collective investment scheme</b>	6 + D%	6%	6%	7 years	
<b>Personal pensions / SHP</b>	6 + D%	6%	2.5%	10 years	
<b>Income withdrawals</b>	6 + D%	6%	0%	10 years to age 70	6% to allow for income withdrawals

## The 'menu' market average: Data Collection Questionnaire

**Important: Please read these notes before completing the questionnaire**

1. This Data Collection Questionnaire should be completed by packaged product providers. We are requesting this information under our powers to gather information contained in section 165(1) of the Financial Services and Markets Act 2000.
2. The purpose of this questionnaire is to identify:
  - the **commission** payable after allowing for any rebating or discounting to the adviser firms; or
  - in the case of either tied sales forces and associated companies, **commission equivalent**.

Your disclosure should include the amount of commission payable after allowing for any rebating or discounting. For example, if less commission is paid to the adviser firm than was offered because there has been a deal to rebate commission directly into the contract, you should provide details of the net amount of commission actually payable, not what would have been payable on standard terms.

### Filling in the form – practicalities

3. We are sending this request to you by post in the first instance, but the questionnaire has been set up as an Excel spreadsheet, and we would prefer it if you would provide us with a completed electronic version rather than a paper reply. If you will kindly email [address@fsa.gov.uk] under the subject 'Menu data collection questionnaire' we will be pleased to provide an electronic copy to your nominated contact.
4. Where you have more than one commission option or set of rates for each product or more than one product in the product group, please include extra lines under each product group showing each product and variations. Definitions of the product groups are given in COB4 Annex 7R Note 10, a copy of which is attached for ease of reference. For example, on a bond, there may be an initial commission, initial commission plus trail, fund based commission alone, or various rates of these. Add as many further lines as are necessary to cover all product types and commission variations on business written within the product group.
5. Where a contract term or age at entry is specified for regular premium contracts, please include business written within plus or minus one year of the specified term or age. For example, where age 40 is specified for the whole of life assurance, include all business where the policyholder was over age 39 exact and under age 41 exact; where a term of 25 years is specified

for personal pensions, include all business for terms over exactly 24 years and less than exactly 26 years.

6. Where possible, disclose the amount of contributions in column 7 that relates to the data in that particular row. As a cross-check, columns 8 or 10 express the initial commission on that tranche of business as a percentage. But we recognise that you may not have access to data from your systems in this particular way. Where that is the case, it will be acceptable as an alternative to omit columns 7 and 9, to provide an estimate of the commission percentages, and to complete columns 8 or 10 directly. If this method is used, please supply separately brief details of how the estimates have been calculated.

### **What to include**

7. Please disclose the commission paid and expected to be payable for contracts issued in the three month period identified in the table (1 April 2004 to 30 June 2004). We will need to repeat the data collection process from time to time, but it is not our intention to ask for data for every calendar quarter.
8. Include top-ups to existing contracts (but omit indexed or automatic premium increases – see note 12).
9. Please calculate commission data using level premium business (i.e. where there is no automatic contractual increase).
10. Include business only where some commission is payable or where the commission-equivalent is non-zero.

### **What to exclude**

11. Ignore sales followed by cancellations in the same period.
12. Exclude from columns 6 to 17 business written on the basis of an automatic contractually increasing premium (but include the initial annualised premium in column 5 – see note 14).
13. Exclude entirely business in nil commission or nil commission-equivalent terms, on the basis that such business is likely to have been transacted on a fee basis.

### **Special cases**

14. For contracts where there are *contractually increasing premiums*, include the initial annualised premium amount in column 5 but exclude these contracts from columns 6 to 17 inclusive.

### **Non-standard arrangements**

15. If your commission or commission-equivalent structures do not fit this questionnaire, please contact email [address@fsa.gov.uk] or write to [name, address] as soon as possible. We will discuss a suitable approach with you and may ask you to provide equivalent information, showing amounts or percentages on a separate sheet and including the volume of the particular contract sold.

### **Submitting the questionnaires**

16. Please submit the completed questionnaires (preferably as completed Excel spreadsheets) to [address@fsa.gov.uk] or by post to [name, address] to arrive by **31st July 2004**. If you have questions about the questionnaires, please get in touch with [name, tel no, email address] in the first instance.

Data Collection Questionnaire for Product Providers  
Regular Premium Contracts

Return on behalf of:	Contact name:
For the period from: to:	Contact telephone:
	Contact email:

Product Group and contract name	Specified term or age	Business volumes		Initial Commission					Trail / Renewal Commission					
		Sum of annual contributions for all terms (£)	Sum of annual contributions for this data row (and specified term) (£)	Total initial commission payable immediately at start of contract (indemnity or fully earned) (£)	Avg initial comm % (=col 5 ÷ col 4)	Spread Initial Commission			Ongoing fund-based comm			Ongoing premium-based comm		
						Total initial commission (£)	Avg spread initial comm % (=col 7 ÷ col 4)	Spread period for spread initial comm	Start month for trail comm	Last month for trail comm	Comm rate as % of fund	Start month for renewal comm	Last month for renewal comm	Comm rate as % of premium
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Collective investments (eg unit trusts)	Any													
Endowments	10 yr term													
Whole of life assurance	Age 40													
Long term care protection	Age 65													
Personal and Stakeholder pensions	25 yr term													
Personal and Stakeholder pensions	10 yr term													

Data Collection Questionnaire for Product Providers  
Single Premium Contracts

Return on behalf of:									Contact name:					
For the period from:									Contact telephone:					
									Contact email:					
Product Group and contract name	Specified term or age	Business volumes		Initial Commission					Trail / Renewal Commission					
		Sum of single contributions for all terms (£)	Sum of single contributions for this data row (£)	Total initial commission payable immediately at start of contract (£)	Avg initial comm % (=col 5 ÷ col 4)	7	8	9	Ongoing fund-based comm			Ongoing premium-based comm		
									Start month for trail comm	Last month for trail comm	Comm rate as % of fund	Start month for renewal comm	Last month for renewal comm	Comm rate as % of premium
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Collective investments (eg unit trusts)	Any													
Investment bond	Any													
Long term care	Any													
Annuities	Any													
Income drawdown	Any													
Personal and Stakeholder pensions	Any													



# Statement by PricewaterhouseCoopers LLP

1. PricewaterhouseCoopers LLP was asked to assist the FSA in its consideration of the market average. Our role was concerned with the processes; accordingly, consideration of wider issues such as whether the menu would meet its objectives in the context of the overall sales process, the appropriateness of the overall proposals and analysis of the proposed calculation of commission equivalence were outside our scope.
2. The FSA and ourselves, based on discussions with a number of trade bodies and product providers, have identified a number of issues primarily relating to:
  - product groupings;
  - calculation and use of the market average; and
  - the processes for data gathering and interpretation.
3. To resolve these issues, some approximations will be required. With this proviso, the FSA has been keen to ensure that the quoted market average can be computed from the data provided to it and that independent assurance could be given on its calculation. On the basis of the information we have available, we believe that these objectives are capable of being met and, in the aspects covered by our work, the proposals are suitable for consultation.



# List of questions asked in this paper

- Q1: Do you agree with our proposal for firms to give an indication of the cost of advice early on in the advice/sales process?
- Q2: Do you think that our proposals for enhanced disclosure by way of the menu will add to the time taken to go through the advice/sales process? If so, we would be pleased to receive any data that would help quantify any extra time needed.
- Q3: Do you agree with our proposals concerning the circumstances in which a menu must, or need not, be provided?
- Q4: Do you have any comments on our proposed format of the menu? In particular, we would welcome comments on our use of the 'key facts' logo, the regulatory message and the table of commission information.
- Q5: Do you agree with our selection of products and product groups?
- Q6: Do you have any comments on either or both methods we propose by which firms with different commission shapes determine which maximum is to be included in the menu?
- Q7: Do you agree with our proposals to collect gross commission data from product providers?
- Q8: Do you agree with our proposals to collect rebating data from a sample of adviser firms?
- Q9: Do you agree with our proposed method for calculating market average figures?
- Q10: Do you agree with our proposals for changes to the guidance on the method of calculation of commission equivalence?
- Q11: Do you think that our approach to commission disclosure will increase consumer understanding?

- Q12: Does the proposed menu meet the key information needs of consumers?
- Q13: Do you agree with this policy change to the draft rules in CP166?
- Q14: Do you have any comments on our proposed implementation timetable?
- Q15: Do you agree with the cost estimates of our proposals? If not, do you have further information that we should take into account in these estimates?
- Q16: Do you agree with the benefit analysis of our proposals? If not, what considerations should we take into account in this analysis?