



Financial Services Authority

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

December 2008

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1 Introduction

Background

1. In November 2007, some significant changes to our Handbook requirements came into force, with the introduction of a more principles-based Conduct of Business sourcebook (COBS) for investment business. COBS replaced the old COB sourcebook.
2. Our 2008/09 Business Plan explained that we would conduct a post-implementation review of COBS, running through to 2010 which reflects our view that it will take time for some outcomes for consumers, firms and markets to become apparent. We said we would communicate interim findings in 2008. This statement sets out our high-level interim findings about how firms have responded to the rule changes, to the extent that they have been identifiable since November last year.

Scope and approach

3. When introducing COBS, we emphasised that we intended to promote improved standards of consumer protection through a greater emphasis on outcomes, rather than through a large body of detailed rules prescribing how to achieve these outcomes. We reformulated COBS to allow firms greater flexibility in aligning regulatory requirements and business practice. But, as we stressed, more outcomes-focussed regulation does not imply any easing of regulatory standards or of our expectations of firms' behaviour. It challenges firms to ensure they meet those clearly stated outcomes.
4. We have sought to review the introduction of COBS against specific outcomes that we intended it to achieve, including:

- COBS is more accessible and more cost effective to operate for us and for firms; and
 - firms have and use more discretion over how to achieve regulatory outcomes in the context of their particular business models, thereby facilitating appropriate outcomes for themselves and for consumers.
5. This statement is based on evidence collected during 2008 from surveys of a sample of retail intermediaries and their advisers; visits to a sample of larger investment firms (including affected insurance firms); a review of additional documentation obtained from other relevant FSA work and direct from firms; and views solicited from a range of industry associations and other stakeholders¹.
6. We recognise that our findings have been gathered within the main transitional period. These findings are therefore only initial indicators rather than final conclusions. We also recognise that in a number of areas it has been (and will continue to be) difficult to distinguish between the impacts and outcomes driven by changes to COBS and those driven by other regulatory initiatives (notably firms' responses to our Treating Customers Fairly priorities). This combination of drivers is challenging for any measurement process, but unavoidable. We have sought to distinguish between factors where we can but, in the main, we are not seeking to establish causation between the introduction of COBS and the impacts we identify and assess in all areas. Our initial sample sizes have been small in some areas.

¹ In parallel, we have also undertaken a review to consider how firms covered by the Markets in Financial Instruments Directive (MiFID) have implemented the other priority changes, which we identified in our September 2007 *Statement of FSA Supervisory Priorities* arising from the November Handbook changes. This separate review has focussed primarily on those MiFID-driven changes with wider market implications and those affecting primarily wholesale market firms – particularly best execution, investment research, outsourcing, conflicts of interest and client categorisation. We will publish the report on this MiFID review in January 2009.

2 General interim findings

Accessibility

1. The majority of retail market firms we surveyed, most of their professional advisors and FSA staff generally find that the accessibility of COBS has improved because it is easier to use, understand and navigate than the old COB sourcebook, and that the structure and presentation of the requirements has improved.

Cost of implementing COBS

2. In considering whether COBS is more cost-effective, the post-implementation review is not conducting a formal cost-benefit analysis of the changes². However, we have obtained (and will continue to obtain) some anecdotal evidence on costs over the course of our review. The majority of the smaller firms we surveyed indicated that the burden of the COBS changes on their businesses was minor and their industry associations' feedback echoed this view. Most firms have incurred some one-off costs, at least in considering the need for change, making any changes and necessary training. One-off costs have also arisen from re-printing internal and client-facing documentation and policies. As expected from our pre-implementation work, some COBS changes have also needed some specific systems changes, which have proved more costly.

2 We have commissioned external work – being undertaken by LECG – on the impact of more principles-based regulation (to measure any initial change in firms' regulatory costs, and analyse the related benefits, of more principles-based regulation) which may prove informative on certain COBS changes. We will publish this research in the first quarter of 2009.

Use of increased flexibility/discretion

3. Nearly all the firms we contacted had reviewed their procedures in some way since the introduction of COBS to identify where changes might be required (but had not necessarily changed their procedures as a result). We recognise the important role that compliance consultants have played in this process by helping many smaller firms to respond to the implications of the COBS changes. However, we were still concerned at how many smaller firms described their knowledge of COBS as only 'basic' several months after it came into effect. By now, we will expect this to have improved.
4. Many retail market firms have acknowledged that COBS allows them greater discretion to review their approaches to compliance, but for many this has not been prioritised during the first year of COBS being in place, except in a few specific areas. Some firms have deferred consideration of discretionary changes to their processes and consumer documentation (beyond what is necessary in order to remain compliant) while they focussed on embedding Treating Customers Fairly and awaited more certainty on our Retail Distribution Review (RDR) proposals.
5. Firms' appetite for discretionary change has also been affected by the extent of COBS/MiFID changes they had to make. Where broader change has been required (notably for larger investment firms), some firms appear to have taken the opportunity to carry out more fundamental reviews of their internal processes (one example being the approach to client profiling). We have also noted a degree of caution among firms in how to respond to a more outcomes-focussed regulatory framework because they remain unclear about our expectations in this regard.

Facilitating appropriate consumer outcomes

6. That said, our review has already identified examples of how firms have made changes to meet the revised COBS requirements in respect of financial promotions, initial disclosure document (IDD) and menu information, disclosure of product risks, information gathered about clients, and processes for non-advised investment business (set out below).
7. We have seen management information from certain firms that helps indicate the scale of some potential positive consumer impacts from COBS but this data is early and limited. We expect the realisation of measurable benefits to become more apparent over time as COBS awareness improves with the continued implementation of changes.

3 Interim findings in specific areas

Financial promotions

1. COBS 4 requirements are more high level than the old COB rules, but they have substantially consistent intended outcomes. Important differences include the removal of some product-specific requirements. Initial review findings indicate that while standards have been maintained under COBS, firms are not yet taking full advantage of the flexibility provided. However, many of the firms that issue financial promotions surveyed so far reported changes in the way in which they prepared promotions; for example, earlier engagement between marketing and compliance, increased senior management involvement, and increased management information. Some firms also indicated that they had changed, or planned to change, the wording and/or presentation of risk warnings, which COBS now allows, to reflect the nature of the product better and to make risk warnings more meaningful and relevant to their target market.
2. However, our review suggests there has been little take-up by firms in using the greater flexibility regarding when and how information is provided in direct offer financial promotions and in how past performance information is presented. This is not unexpected given that we have included guidance in COBS 4 (which is based on the previous past performance rules) to suggest how past performance data may be presented.

Information about the firm's services and remuneration

3. We have considered a sample of IDD's (including combined initial disclosure documents) and menus produced since November 2007. This sample included documents that followed the COBS guidance templates, as well as documents developed by firms using the COBS flexibility.

4. Of the documents that aimed to follow the IDD/menu templates in the November 2007 COBS guidance, a surprisingly high proportion still failed to comply in various specific respects. Breaches included missing registered trademark symbols when using the 'keyfacts' logo, missing information on the varying cost of personal pension schemes, and presenting incorrect payment options. We also discovered numerous examples where text on disclosure requirements was either out-of-date or it contained incorrect regulatory information on specific points such as Home Reversion schemes.
5. On the other hand, the documents developed by firms (or their advisers) as an alternative to using the COBS guidance templates fared quite well in the assessment. All were compliant and sought to make good use of the flexibility that COBS permits, with some firms commenting to us that their own templates were more compatible with their business models. For example, a number of firms had chosen to combine the 'menu' disclosures with their client agreements, omitting previously required disclosures not relevant to them. However, of the documents we saw, only 10% used a firm's own format. This figure suggested that firms did not have the desire or the resources to change formats yet, or they were nervous about risks of non-compliance.
6. We have built on the November 2007 COBS 6 guidance by introducing the Services and Costs Disclosure Document (SCDD) in August 2008. For firms wishing to use this document, it may further reduce the number of documents investment advisers provide at the point of sale, and give firms greater flexibility in achieving clarity for consumers. However, it is only one way for firms to meet the COBS disclosure requirements: firms will remain free to develop their own material in order to comply. We will wish to see how firms respond to this further development.

Suitability

7. We have some evidence that firms believe that the reformulated suitability standards in COBS 9 are more coherent and better articulated than those in COB, and that this may promote better consumer outcomes. Firms generally supported our decision to apply one (MiFID-driven) set of revised suitability requirements in COBS to advisers selling all types of investment products. We also have some evidence of investment firms having changed documentation and processes, though we have minimal evidence of the effects of these changes at this stage.

8. We have seen some good examples of positive change from the small sample of large investment firms reviewed so far, usually in respect of their private clients. But the picture for retail intermediaries remains mixed: those firms that previously demonstrated good standards of fact-finding and explanation of recommendations in their suitability letters/reports continue to do so, as do those that previously demonstrated poorer standards. Evidence so far indicates that around 50% of firms surveyed have made changes to the format/approach of their suitability reports since November 2007. However, with only two exceptions, the sample documentation reviewed does not demonstrate the degree of change and improvement this figure would imply in terms of clearer, more targeted presentation of information. We were disappointed to see that more firms have not used the greater flexibility in COBS as an opportunity to improve their suitability reports. These findings underline the need for us to continue to reinforce messages around quality of advice processes.
9. We cannot yet identify significant quantifiable benefits to clients categorised as professional from the extension of detailed suitability requirements to cover them. However, discussions with firms and their representatives suggest that firms may be applying a greater discipline in their processes for investment advice and portfolio management for professional clients, because of MIFID implementation in this area. If COBS promotes greater discipline around client assessments and clarification of client objectives and circumstances, this should produce benefits for these clients.

Appropriateness test

10. The COBS 10 appropriateness test for a range of non-advised investment services introduced by MiFID had no direct precedent in the previous COB rules. After only a year, data on effects and any changes in consumer outcomes in this regard is therefore inconclusive. Nearly all of the firms we have reviewed so far have made changes that respond to the intended outcomes of the requirement and we have found some good examples of specific responses and approaches to implementation. Firms are not yet convinced whether benefits are arising that justify the costs of the test's implementation and operation. However, we have already found some evidence of potential benefits to vulnerable consumers, especially in terms of helping to promote client awareness of risks associated with products that are more complex. This is through a better highlighting and reinforced disclosure of relevant risks by means

of questions asked of clients, warnings given and the encouragement firms give clients to access information they make available. In 2009, we will be working with stakeholders to confirm and, where possible, quantify specific outcomes and benefits experienced by consumers.

11. Feedback suggests that our approach to the implementation of the appropriateness test has been proportionate and balanced, and that our additional guidance and Q&A material has been helpful. We received further support for our decision not to apply the MiFID appropriateness test much more widely than the directive required. The most significant issue arising from this stage of our review relates to some questions about the application of the appropriateness test to non-financial spread betting where firms offer this business through direct offer financial promotions. We are following this up with the relevant firms.

Product information disclosure

12. Our desired outcome for the COBS 13 and COBS 14 rules is for retail clients to be given understandable key features documents (KFDs) and key features illustrations (KFIs) that they will read. Firms need to portray their KFDs and KFIs as important information and to write them in a way that is understandable by the intended audience. As the main COBS transitional period has only just ended, we can only take a limited view of any changes made. However, our review of a sample of KFDs and the improvements already made by some firms show that the standards we expect are achievable and reasonable.
13. Industry association feedback indicates that firms have welcomed the simplification of these rules (including the removal of the requirement to provide post-sale KFDs and KFIs) but for cost reasons (such as the cost of making changes to KFI and post-sale systems), there has not yet been widespread use of the extra flexibility presented.
14. We looked at firms' responses to the changes to our COBS 4 rules on projections of future performance, which now differentiate between MiFID and non-MiFID products. Projections are not mandatory for MiFID products but, if firms choose to produce them, they must be based on reasonable assumptions and objective data. So far, we have found only a few firms that produce projections for MiFID products: there seems to be little demand from advisers or clients for this. The few examples of MiFID projections that we found appear to have been based on the standardised rates that would have applied under COB

rather than on the firms' own analysis. The COBS rules for products caught under MiFID require firms that choose to provide projections to do so having done their own analysis based on reasonable assumptions and supported by objective data. We do not issue standardised rates for those products under COBS so firms will need to have appropriate justification for the rates they use. We will be considering further firms' use of projections and how firms determine the rates that they use in respect of the assumptions and the data used.

15. We amended the projection rules for non-MiFID products to allow firms more scope to produce generic (as opposed to personalised) projections and to choose not to produce projections at all where they do not add value or context (ie: where a retail client will not need a projection to be able to make an informed decision about whether to invest). The majority of firms surveyed so far stated that they had not replaced personal projections with generic projections. The main reasons given for this were the cost of making system changes and the continued demand from advisers for personal projections.
16. In September 2007, we published a report³ highlighting good and poor practice in KFDs and making clear our expectation for review and, where necessary, improvement by the end of 2008. We will publish an update on our review of the quality of KFDs in the first quarter of 2009.

3 *Good and poor practices in Key Features Documents* September 2007.

4 Next steps

1. We have not identified any areas of COBS at this stage (within the scope of our review) where we feel substantial rule changes would be appropriate. However, we have noted some issues relating to the clarity of the scope/application provisions, which we are considering for action in 2009. Further points will be collected and assessed during the remainder of the review⁴, with any resulting proposals for specific improvements to COBS progressed through our usual consultation processes (either in a quarterly CP or together with our consultation on COBS changes in respect of the RDR).
2. Our post-implementation review will continue in 2009 by seeking to confirm and measure the impact of the COBS regime on consumer outcomes and the behaviour of firms, and continuing to work with firms and other stakeholders. We will continue to gather data over the course of 2009 from which we can draw further conclusions and we will publish the findings of the review in 2010.
3. We will keep our COBS webpages⁵ under review and update them when appropriate. In particular, we may include examples of good and poor practice that we have found during our post-implementation review.

⁴ We are aware that representatives of the private client sector continue to have concerns about the way in which COBS requirements for retail investment products apply to their sector in a way they regard as inappropriate. COBS has not increased these concerns and in some respects has helped; for example, the flexibility allowed in how IDD/menu information is disclosed. However, the sector believes that issues they have voiced over several years remain.

⁵ www.fsa.gov.uk/Pages/Doing/Regulated/newcob, which already includes several case studies and Questions and Answers (Q&As).

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