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# Advisory

## Reforming the FSA Conduct of Business Rulebook

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### FSA, MiFID and COB Reform

The Financial Services Authority (FSA)<sup>1</sup> is the regulator of the United Kingdom investment services industry. The FSA Handbook<sup>2</sup>, which comprises all the rules, regulations and guidance for investment firms, is the bible every investment firm must consult. The Handbook is not a bedtime read, and is more than 20,000 pages long. Recently, the FSA has been moving toward a slimmed-down Handbook, with more high-level rules, that will be simpler to read and easier to understand. As part of this ongoing regulatory downsize drive, the FSA is taking advantage of its obligation to implement MiFID<sup>3</sup>, the latest EU harmonising directive on investment services' regulation, and to update and abridge the Conduct of Business (COB) rulebook<sup>4</sup>, which regulates investment firms' dealings with customers. It is doing this for two reasons: the first is that there is considerable overlap between the MiFID and COB regimes – the FSA is therefore going to copy MiFID into COB and delete any COB overlap; the second is that COB, like much of the rest of the Handbook, has become extremely complex and unwieldy from having had so many rules tacked on from time to time.

### Comment

Given that the FSA has to implement MiFID anyway, now would seem like an excellent time to overhaul COB and make it more business-friendly. However, it is not all good news. COB applies to almost all investment firms. MiFID applies only to some investment firms. In copying MiFID into COB, the FSA is, as usual, over-regulating, by applying legislation unnecessarily to firms that were previously not within the scope of such legislation. The FSA argues that it is not doing this and that it will only apply MiFID rules to non-MiFID firms

where such firms were already obliged to comply with MiFID-style rules by COB. This is generally but not strictly true. In any case, this will not result in a simpler-to-read, easier-to-understand Handbook. This will result in a Handbook with a two-tiered application, where some of the rules will apply to both MiFID and non-MiFID firms, and some of the rules will only apply to MiFID firms while retaining the current COB regime for non-MiFID firms. This paper therefore examines the changes proposed to COB by the FSA from the perspective of both MiFID and non-MiFID firms.

### **FSMA, FSA, and Regulated Firms: Background**

The UK financial services industry accounts for approximately 7% of GDP and employs more than 1 million people UK-wide. The Financial Services and Markets Act 2000<sup>5</sup> sets out the legal framework for this industry, within which the FSA, the regulator of the Act, authorises and regulates firms within the industry. The sorts of businesses that require authorisation and are regulated by the FSA include banks, building societies, insurance companies, friendly societies, credit unions, Lloyd's of London, investment and pension advisers, stockbrokers, professional firms offering certain types of investment services, fund managers and derivatives traders.

### **What is the Conduct of Business Rulebook?**

The FSA Handbook comprises the raft of rules that regulate authorised firms. COB is part of the Handbook and sets out the rules the firms must follow in carrying out investment business with customers. It covers, among other things, financial promotions, the provision of information and advice to clients, non-advised services and dealing in and managing investments.

### **Who Does COB Apply to?**

COB applies to all regulated firms with regard to any regulated activity except mortgages and insurance mediation in connection with non-investment insurance contracts.

### **Why is it Going to be Reformed?**

COB is currently 701 pages long. On 31 October 2006, the FSA published a consultation paper, CP06/19, Reforming Conduct of Business Regulation<sup>6</sup>. CP06/19 proposed simplifying COB as part of the FSA's current move toward more principles-based regulation and away from detailed prescriptive rules. The FSA is aiming to remove around half the content of the old rulebook, with the end result being a new Conduct of Business rulebook, NEWCOB. These changes are taking place in the context of the FSA's obligation to implement MiFID.

### **What is MiFID?**

MiFID is the European Union Directive (2004/39/EC) on markets in financial instruments, and replaces the Investment Services Directive 1993 (ISD). The ISD set out basic high-level provisions governing the conduct of business regulation that should apply to firms providing investment services. MiFID has the same basic purpose; however, it also makes significant changes to the regulatory framework to reflect developments in financial services and markets since the ISD was implemented.

### **Who Does MiFID Apply to?**

MiFID covers most regulated firms. It includes investment banks, portfolio managers, stockbrokers and broker dealers, corporate finance firms, many futures and options firms and some commodities firms. In some

other areas, the position is less clear-cut. Retail banks and building societies are subject to MiFID for some part of their business but not for others. The type of regulated firms that tend to fall outside MiFID includes operators of collective investment schemes, occupational pension schemes firms, life companies and friendly societies, financial advisers that do not hold client assets and authorised professional firms.

## So?

COB applies to more regulated firms than MiFID. The FSA is going to update COB based on changes to the regulatory framework set out in MiFID. Therefore, firms that were not going to be affected by MiFID will be affected by MiFID because they will have to comply with the MiFID changes to COB. Conversely, the FSA maintains that COB generally said much the same as MiFID, that changes are generally to the wording of COB and not to the substance of COB, that not all changes made to COB will apply to non-MiFID firms and that the changes to the wording and the abridgement will make COB simpler and easier to understand and use.

## When Will the MiFID Changes to COB Come into Force?

MiFID is required to be implemented by or on 1 November 2007.

## What Will the MiFID Changes to COB Entail?

**Acting honestly, fairly and professionally.** Article 19(1) of MiFID requires firms to act honestly, fairly and professionally in accordance with the best interests of their clients. This requirement is not in COB but is in the FSA Principles for Businesses<sup>7</sup>, which apply to all authorised firms. Principle 6 says that a firm must pay due regard to the interests of its customers and treat them fairly. The FSA is copying 19(1) into NEWCOB. Some firms have responded that this is unnecessary as it is covered off by Principle 6, but the FSA states that 19(1) goes slightly further than Principle 6.

**Providing information to clients.** Article 19(3) of MiFID requires firms to provide appropriate information to clients in a comprehensible form about the firm and its services, financial instruments and investment strategies, execution venues and costs and associated charges. There is currently no equivalent of 19(3) in COB, and the FSA is copying 19(3) into NEWCOB. However, the FSA does not intend to apply 19(3) to non-MiFID firms. This is because the FSA considers that its current regime of the Initial Disclosure Document and the Menu (fees and commission statement), which applies to firms advising on packaged products, is sufficient for the market. The FSA plans to consult as to how best to merge 19(3) with the IDD and the Menu.

**Communications to clients.** Principle 7 of the FSA Principles requires firms to pay due regard to the information needs of their clients and to take reasonable steps to communicate in a way that is clear, fair and not misleading. Currently COB rules highlight this requirement and provide further detailed compliance requirements. MiFID 19(2) says that all information including marketing information shall be fair, clear and not misleading. It also contains high-level rules relating to identity, accuracy and balance, sufficiency in client understanding and prominence. The FSA is going to copy these out and apply them to MiFID and non-MiFID firms. There is little or no difference in the two regimes. However, MiFID also requires firms to include particular detail on the sources of information and key facts and assumptions used to make comparisons in all communications. This is not currently required, and the FSA is going to apply these requirements only to MiFID firms.

**Financial promotions.** Principle 7 applies here too. As above, the FSA is going to copy out 19(2) and related high-level rules. In particular, there are four high-level rules firms should consider under the new regime.

1. **Comparative promotions.** MiFID requires firms to include particular detail on the sources of information and key facts and assumptions used to make comparisons in all communications. This is not currently required, and the FSA is going to apply these requirements only to MiFID firms.
2. **Performance information.** This rule is going to change. The new rule, which will apply to all communications, marketing or otherwise, within MiFID's scope, will require that past performance disclosure must not be the most prominent feature of a communication, a past performance risk warning must be included, and the information must cover at least the immediately preceding five years, or all years if less, and not less than 12 months. It will therefore not be possible to provide past performance for funds with fewer than 12 months' performance. This is stricter than MiFID.
3. **Marketing communications to be clearly identifiable.** MiFID requires that marketing communications shall be clearly identifiable as such. This provision is not currently in COB, but firms ought to have been complying already with this in order to comply with Principle 7.
4. **Appropriateness test.** MiFID introduces an 'appropriateness test' for all complex products sold by MiFID firms to retail clients. The appropriateness test requires the firm to seek information from its client or potential client about his relevant knowledge or experience in the applicable investment field so that the firm can determine whether the investment service or product is appropriate for the client. If the firm concludes that it is not, it must warn the client. The FSA is going to copy out the MiFID text, which therefore replaces the current COB 'may be suitable' assessment.

**Inducements.** The current rules prohibit firms from accepting an inducement if it is likely to conflict to a material extent with any duty firms owe their customers. MiFID contains broadly similar provisions. The FSA is copying out these provisions into NEWCOB. There are three differences between the current COB rules and the MiFID provisions: COB permits firms to offer, receive or accept a benefit provided that it is unlikely to conflict to a material extent with any duty that a firm owes to its customers, whereas the MiFID provisions apply to all payments, fees or non-monetary benefits regardless of materiality and therefore go wider; the MiFID provisions introduce a new requirement that a fee, commission or non-monetary benefit, where this is paid or provided to or by a third party, 'must be designed to enhance the quality of the relevant service to the client'; and the MiFID provisions require firms to disclose to the client the existence, nature and amount of the fee, commission or non-monetary benefit or the essential details in summary form, while there is no equivalent in COB.

The FSA is going to apply the first difference to non-MiFID firms but not the second or third.

**Client categorisation.** COB rules on categorisation of clients trigger other COB rules to be applied depending on how the client is characterised. The MiFID provisions use different categories and terminology to COB. The FSA is going to copy out the MiFID provisions. With regard to non-MiFID firms, the FSA is going to apply the regime in a diluted version. It is going to use the nomenclature of MiFID categorisation (categorising clients as 'retail', 'professional' or 'eligible counter-party') but will provide modified definitions and the use of grandfathering where appropriate.

**Statutory status disclosures.** COB rules currently provide that firms conducting investment business are required to provide information about who they are and what their statutory status is in every written communication, including letters and business cards. MiFID introduces different status disclosure requirements for firms. The FSA is going to copy out the MiFID provisions but not apply them to non-MiFID firms, to whom the current regime will continue to apply.

**Client agreements and terms of business.** Currently, COB requires that firms provide customers with the terms on which they provide services, and details the particular content and format this information must take. Article 19(7) of MiFID echoes this requirement but does so in a more high-level format, without prescribing the content and format such provision must take. The FSA is going to copy out article 19(7) and remove its current restrictive requirements on content and format. The FSA has concluded that, although 19(7) seems not to apply to firms that only offer investment advice to their clients, in reality it does apply to such firms, except where they offer unsolicited advice.

Respondents to CP 06/19 requested that the exemption from this requirement applicable to life policies be retained. In its Policy Statement 07/2, Implementing the Markets in Financial Instruments Directive<sup>8</sup>, the FSA stated that as life policies are non-MiFID business anyway, it would consider the issue and respond in the forthcoming policy statement NEWCOB PS.

**Non-advised services.** Non-advised services are MiFID investment services that do not involve advice or discretionary portfolio management. Articles 19(5) and (6) of MiFID introduce an ‘appropriateness test’ for such services (as above). There is no direct equivalent of the appropriateness test in COB. The FSA is going to copy out the MiFID text but will not apply it to non-MiFID firms or products, apart from one exception: the FSA is going to replace the current ‘may be suitable’ assessment for direct-offer financial promotions with the MiFID appropriateness test.

**Dealing and managing.** COB’s best execution requires a firm to take reasonable care to ascertain the best available price and execute at a price no less advantageous to the customer. MiFID’s best execution requirements are more extensive and prescriptive than COB’s, and lose COB’s current safe harbour system in relation to securities traded on the London Stock Exchange Trading System. The FSA is going to replace the current COB rules with the MiFID equivalent, but is going to apply the new rules solely to MiFID business.

**Investment research.** Currently, COB rules prohibit firms from dealing ahead of any publication or distribution of investment research except in certain circumstances, and require firms that publish or distribute ‘impartial’ research to establish and operate a conflicts-of-interest policy. MiFID contains broadly similar provisions, and the FSA is going to copy –out the MiFID equivalent. There are one or two differences. The MiFID definition of investment research is objective or independent research. This is narrower than COB’s definition. However, MiFID applies to both oral and written material, whereas COB focuses on written. Ultimately, this means that MiFID and non-MiFID firms will have to review their policy of publishing/distributing research to incorporate oral dissemination, and that those firms publishing non-independent research will have to ensure that any publication/distribution clearly identifies such material as a marketing communication and complies with the applicable rules for financial promotions.

**Preparing product information.** Currently, COB rules require firms to produce and provide to customers point-of-sale information, consisting of a Key Features Document (KFD), a Simplified Prospectus (SP) (for UCITS products) and information on how charges may affect the investment. The MiFID rules incorporate new terminology (where COB refers to firms and product providers, MiFID refers to intermediaries and investment services and activities) and apply to a wider range of products than COB (which applies solely to packaged products), but are far more high-range than COB, which is detailed and prescriptive. The FSA is going to copy out the MiFID provisions but retain its original KFD and SP requirements, which will apply to both MiFID and non-MiFID business. It will, however, incorporate MiFID’s exemption that projections need not be issued for MiFID business, and will in due course invite responses as regards projections for non-MiFID business; meanwhile, non-MiFID firms must continue to comply with existing COB requirements.

**Customers' understanding of risk.** COB currently sets out both high-level rules as to the analysis of a customer's understanding of the risks involved that firms must carry out before recommending or executing an investment, and detailed and prescriptive rules as to the format any applicable warnings should take. The equivalent MiFID provisions contain high-level rules but no detailed and prescriptive rules. The FSA is proposing to copy out MiFID and delete its own detailed and prescriptive rules for MiFID firms. The new regime will also apply to non-MiFID business involving retail clients only, where the activity is one of investment advice, discretionary portfolio management, receiving and transmitting orders in warrants and derivatives or stock lending. The current regime will otherwise continue to apply.

**Reporting information to customers.** Currently, COB rules prescribe that firms report to customers when they execute a sale or a purchase of a designated investment for that customer. MiFID replicates these rules, but does not go as far as COB in the detailed requirements for such reporting. The FSA is going to copy out MiFID but also to retain its detailed requirements for disclosures to retail clients regarding derivative and option contract notes, disclosures about particular trading circumstances and the additional detailed content to be included in a periodic statement for a portfolio that contains a contingent liability investment. Otherwise the FSA will delete rules not replicated in MiFID.

**Know your customer.** COB currently requires that before a firm gives a personal recommendation to a private customer it must take reasonable steps to ensure that it has sufficient personal and financial information about that customer. MiFID contains broadly similar provisions, but covers professional as well as retail clients. The FSA is going to copy out the MiFID provisions into NEWCOB and apply them to both MiFID and non-MiFID firms with regard to private customers, but only to MiFID firms with regard to professional clients.

**Use of dealing commissions.** COB's current rules on dealing commissions limit investment managers' use of dealing commissions to execution services and research, and require them to make adequate disclosure to the customer of the firm's policy and of the type of goods and services received. These rules go further than MiFID. The FSA is going to retain the current regime.

**Specialist regimes.** Currently COB contains several specialist regimes, such as the trustee firms' regime, energy and oil market activity, corporate finance, stock lending and venture capital and the retail securitised derivatives regime. These modify applicable COB rules to provide concessionary treatment to qualifying firms. These regimes will be affected by MiFID implementation, as it will not be possible for the FSA to modify or disapply the conduct of business rules that implement MiFID provisions. However, the FSA is exercising a softly-softly approach, and will apply rules in NEWCOB to qualifying firms only to the extent required to implement MiFID, and where a rule was disappplied under the COB regime will continue to disapply that rule unless it clashes with MiFID.

### Further Guidance on the Application of MiFID Requirements to Non-MiFID Business

Further guidance on the application of MiFID requirements to non-MiFID business will be set out by the FSA in the forthcoming NEWCOB Policy Statement.

### Non-MiFID Business Consultation

Annex 5 of CP 06/19 sets out a list of non-MiFID business that was not included in the FSA's consultation. The FSA will be consulting further on the following early in 2007: venture capital business or corporate finance business falling outside the scope of MiFID or carried on by non-MiFID firms, commodities business, sports and leisure spread betting, Lloyd's business, collective investment schemes and their operators,

occupational pension scheme firms, provision of investment research by non-MiFID firms and credit institutions on a standalone basis, locals, service companies, business falling within the existing regimes for depositaries and trustees, best execution and order handling for all firms outside the scope of MiFID, client categorisation rules concerning the professional client/eligible counterparty boundary outside the scope of MiFID, requirements relating to projections of future returns and the effect of charges for packaged products.

### Non-MiFID changes to COB

**Distance marketing directive.** Directive 2002/65/EC concerning the distance marketing of consumer financial services<sup>9</sup> requires firms concluding distance contracts to provide customers with minimum standard information about the firm and the product/service being offered. This was implemented piecemeal throughout COB. The FSA is going to group the DMD rules together, remove superfluous DMD guidance and simplify some defined terms.

**Electronic commerce directive.** The FSA implemented the requirements of Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market<sup>10</sup> as the ECO sourcebook. It now intends to delete this, and insert simplified provisions from the ECO sourcebook into NEWCOB.

**Customer cancellation rights.** MiFID does not prescribe cancellation rights as a tool for consumer protection, but the FSA is going to reform its regime anyway as the current rules are complex and difficult to follow; in particular, the FSA is considering extending the regime to non-distance advised stakeholder CTFs and removing the right to cancel post-sale variations.

**Insurance mediation.** Firms offering life insurance must comply with the EU Insurance Mediation Directive (2002/92/EC)<sup>11</sup>, which was incorporated into COB by the FSA, and sets minimum disclosure standards before the conclusion of any life insurance contract. The FSA proposes to reform and simplify its current regime and in particular is going to remove the requirement for firms to produce an Initial Disclosure Document for non-advised sales to retail clients. Feedback on the FSA's proposals will be set out in the forthcoming NEWCOB PS.

**Claims handling for long-term care insurance.** Long-term care insurance (LTCI) contracts are policies that pay benefits in the event of the policyholder's permanent or mental incapacity, and were created in the 1990s in response to the growing need for nursing and personal care for the elderly and long-term sick. Currently the COB rules ensure that claims are handled fairly and settled promptly, that conflicts of interest are disclosed and that policyholders are properly informed regarding the claims-handling process. The FSA is proposing to replace the existing rules with fewer high-level rules, and to edit the rules to suit the particular market, for example recognising that someone else may be acting on the policyholder's behalf.

**With-profits.** The existing provisions cover rules and guidance on treating policyholders fairly, governance of firms, requirements on firms to publish the Principles and Practices of Financial Management in accordance with which they are to run their funds, and safeguards for policyholders when firms close to new business or propose a reattribution. These rules were introduced relatively recently, following the FSA's 2001-2005 review. Therefore the FSA does not propose any fundamental review of the existing rules until there has been sufficient opportunity to see how they work in practice, although it will replace some wording with more high-level wording where appropriate.

**Pensions.** The current rules require that a specialist advisor oversees pension transfer business. There are also detailed rules about the content and format of a pension transfer analysis that must be completed before a transfer is made. The FSA is going to retain this regime, and is only proposing to edit the wording so that the rules become more high-level.

## Conclusion

The FSA is required to implement MiFID. Many of MiFID's provisions cross over into the COB rules. The FSA has therefore resolved to insert MiFID provisions into COB, at the same time abridging COB and making it more high-level and less prescriptive and detailed. This should make understanding and use of COB simpler and easier. However, because MiFID does not apply to as many financial services and products as COB, and because MiFID and COB terminology are different, this has the end result that NEWCOB clauses will apply to some firms but not others, and that it will be a matter of largely unguided interpretation for firms to decide if they are affected (with financial penalties if they get it wrong). Therefore, it is questionable if NEWCOB is going to have the desired effect envisaged by the FSA, of being a shorter, simpler and easier rulebook. On the other hand, given the crossover between MiFID and COB, it is difficult to see what else the FSA could have done.

## Live Links

[Financial Services Authority \(FSA\)](#)

[The Full Handbook, FSA](#)

[Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004, Official Journal of the European Union, 30.4.2004 \(PDF\)](#)

[Conduct of Business \(COB\), FSA \(PDF\)](#)

[Financial Services and Markets Act 2000](#)

[Reforming Conduct of Business Regulation, FSA, October 2006 \(PDF\)](#)

[Principles for Business \(PRIN\), FSA \(PDF\)](#)

[Implementing the Markets in Financial Instruments Directive \(MiFID\), FSA, January 2007 \(PDF\)](#)

[Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002, Official Journal of the European Communities, 9.10.2002 \(PDF\)](#)

[Directive 2000/31/EC of the European Parliament and of the Council, 8 June 2000](#)

[Directive 2002/92/EC of the European Parliament and of the Council, 9 December 2002](#)



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<sup>1</sup> [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>2</sup> [fsahandbook.info/FSA/html/handbook/](http://fsahandbook.info/FSA/html/handbook/)

<sup>3</sup> [europa.eu.int/eur-lex/pri/en/oj/dat/2004/l\\_145/l\\_14520040430en00010044.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2004/l_145/l_14520040430en00010044.pdf)

<sup>4</sup> [fsahandbook.info/FSA/handbook/COB.pdf](http://fsahandbook.info/FSA/handbook/COB.pdf)

<sup>5</sup> [www.opsi.gov.uk/acts/acts2000/20000008.htm](http://www.opsi.gov.uk/acts/acts2000/20000008.htm)

<sup>6</sup> [www.fsa.gov.uk/pubs/cp/cp06\\_19.pdf](http://www.fsa.gov.uk/pubs/cp/cp06_19.pdf)

<sup>7</sup> [fsahandbook.info/FSA/handbook/PRIN.pdf](http://fsahandbook.info/FSA/handbook/PRIN.pdf)

<sup>8</sup> [www.fsa.gov.uk/pubs/policy/ps07\\_02.pdf](http://www.fsa.gov.uk/pubs/policy/ps07_02.pdf)

<sup>9</sup> [europa.eu.int/eur-lex/pri/en/oj/dat/2002/l\\_271/l\\_27120021009en00160024.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/l_271/l_27120021009en00160024.pdf)

<sup>10</sup> [europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:32000L0031:EN:HTML](http://europa.eu.int/eur-lex/lex/LexUriServ/LexUriServ.do?uri=CELEX:32000L0031:EN:HTML)

<sup>11</sup> [europa.eu.int/smartapi/cgi/sga\\_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=32002L0092&model=guichett](http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=32002L0092&model=guichett)

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